

# **INTERMEDIATE (IPC) COURSE**

## **STUDY MATERIAL**

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**PAPER : 6**

**AUDITING AND ASSURANCE**

**MODULE – 2**



**BOARD OF STUDIES**  
**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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# 6

## Verification of Assets and Liabilities

### Learning Objectives

After studying this chapter, you will be able to –

- ◆ Make a clear distinction between revenue and capital expenditure.
- ◆ Understand provision for providing depreciation and reserves has been dealt in detail.
- ◆ Verify various kinds of assets and liabilities.
- ◆ Identify events occurring after the balance sheet date.

*The act of examining/establishing the existence and valuation of Assets and Liabilities may be referred to as Verification. While verifying the assets and liabilities of an entity, an auditor is required to have knowledge of applicable Accounting Standards, for e.g., AS 6 on Depreciation, AS 10 on Fixed Assets, AS 26 on Intangible Assets, etc. The auditor is further required to check the presentation of various items in the Balance Sheet and Statement of Profit and Loss, for e.g., as per Schedule III to the Companies Act, 2013 in the case of a company.*

### 6.1 Capital and Revenue Expenditure

**Capital Expenditure:** A capital expenditure is that which is incurred for the under mentioned purposes-

- (a) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.
- (b) Making additions to the existing fixed assets.
- (c) Increasing earning capacity of the business.
- (d) Reducing the cost of production.
- (e) Acquiring a benefit of enduring nature of a valuable right.

The different forms that capital expenditure takes are: (i) land; (ii) building; (iii) plant and machinery; (iv) electric installations; (v) premium paid for the lease of a building; (vi) development expenditure on land; and (vii) goodwill; etc.

Expenses which are essentially of a revenue nature, if incurred for creating an asset or adding

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to its value for achieving higher productivity, are also regarded as expenditure of a capital nature. Examples of capital expenditure are-

- (i) Material and wages- capital expenditure when expended on the construction of a building or erection of machinery.
- (ii) Legal expenses- capital expenditure when incurred in connection with the purchase of land or building.
- (iii) Freight- capital expenditure when incurred in respect of purchase of plant and machinery.
- (iv) Repair- Major repairs of a fixed asset that increases its productivity.
- (v) Wages- Wages paid on installation costs incurred in Plant & machinery.
- (vi) Interest- Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

**Revenue Expenditure:** An expenditure, the benefits of which is immediately say within one year expended or exhausted in the process of earning revenue, for example on purchase of goods for sale, on their movement from one place to another, on maintaining assets, on keeping a business organization going, etc. Examples of revenue expenditure are-

- (i) Cost of raw material and stores consumed in the process of manufacture.
- (ii) Salaries and wages of employees engaged directly or in-directly in production.
- (iii) Repairs and renewals of fixed assets.
- (iv) Advertisements.
- (v) Postage.
- (vi) Printing and Stationery.
- (vii) Rent, rates and taxes.
- (viii) Insurance.
- (ix) Interest on borrowings.

## 6.2 Depreciation

**6.2.1 Definition of Depreciation:** Accounting Standard 6 issued by the Institute of Chartered Accountants of India on "Depreciation Accounting" defines depreciation as follows-

"Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose usefulness is predetermined".



The term “depreciable amount” of a depreciable asset as per the standard is its historical cost, or other amount substituted for historical cost in the financial statements less the estimated residual value.

The accounting standard recommends that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

### 6.2.2 Purposes of Providing Depreciation

- (i) **To keep capital intact:** It will be evident that one of the effects of providing for depreciation on an asset is to retain in the business out of the profits in each year, an amount equal to the proportion of the cost of the asset employed in the business that has run off, estimated on the basis of the period of its working life and its scrap value. Thus, the original capital of the entity, assuming that all profits have been withdrawn and losses, if any, made good will remain intact. If, on the contrary, depreciation had not been charged, the net income would have been overstated over the years of the life of the asset, and if the same was withdrawn or distributed as dividends, the business would have no funds for the replacement of the asset.
- (ii) **To ascertain cost accurately:** Unless a proper charge on account of depreciation is included in the Statement of Profit and Loss, the true cost of manufacture of different products will not be ascertained. This is because depreciation is as much a charge against revenue as any other expenditure and must be included in accounts irrespective of the fact whether the final result of a working is profit or loss.
- (iii) **To charge initial costs against earnings:** The cost of a machine less its scrap value can, in effect, be regarded as the price for use of the machine paid in advance for the period it will be rendering service. According to this view unless an appropriate part of this price is charged to the profits of the business each year, the profit earned on its working will not be correctly ascertained.

The object of depreciation accounting thus is to determine on a scientific basis, the proportion of the cost of a machine which must be charged in the accounts of each year during which the machine will be used. Depreciation is an expense incurred for earning profit, which is similar to the hire of an asset, the only difference being that in one case the amount is paid to an outsider while, in the other, it is kept in the entity itself. Therefore, each accounting period must be charged a fair proportion of the cost of fixed assets as the price for their use, and the charge should not be contingent on profits being earned. Accordingly, depreciation is a charge against profits and not an appropriation out of profits.

- (iv) **To prepare true and fair statements:** Unless depreciation is provided, the assets will be shown at an amount higher than their true value and the profit shown will be more than the real profit. In other words, the Balance Sheet and the Statement of Profit and Loss will not be true and fair.

Depreciation should not be confused with any fluctuation in the value of fixed assets. The market price of an asset at the end of a year may be either more or less than its book value. It would be the result of a rise or a fall in the price level, a factor over which the business has no control. Such fluctuation in the value of assets may or may not be taken into account, for fixing the sale price of the articles manufactured, but these must be totally ignored for computing the amount of depreciation chargeable to the Statement of Profit and Loss.

**6.2.3 Depreciation on Wasting Assets:** In terms of the decision in the case *Lee v. Neuchatel Asphalte Co. Ltd. (1889)*, there does not appear any necessity to provide depreciation on wasting assets like mines, quarries, etc. In the present-day context, however, it is highly doubtful whether the principle propounded in the above case would hold good. Wasting assets exhaust by working and necessarily that involves depletion of the capital employed on such assets. It is, therefore, necessary with a view to maintain the capital employed, a charge for such depletion for ascertaining a true and fair view of the accounts. By this process, the cost inherent in depletion would be accounted for and the fair value of the asset would be disclosed in the Balance Sheet. The term depletion stands for depreciation in case of a wasting asset, because here depreciation is really represented by the quantum of diminution of the deposits of materials in the wasting asset.

The legal position governing depreciation in case of a company is contained in the Companies Act, 2013. However, it is enough to know at this stage that in the opinion of the Company Law Board (Now National Company Law Tribunal), depreciation on wasting assets is a necessary charge for arriving at the true and fair picture of the Statement of Profit and Loss and Balance Sheet.

**6.2.4 Methods of Depreciation:** As per AS 6, there are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight line method and the reducing balance method.

**Under the Straight Line Method**, an equal amount is written off each year during the life of the asset.

**Under the Reducing Balance Method**, the annual charge for depreciation decreases from year to year with the result that earlier years suffer to the benefit of later years. Also under this method, the value of an asset can never be completely written off.

The rate of depreciation to be applied in the case of the Reducing Balance Method is substantially higher than that which must be applied under the Straight Line Method if an asset is to be written off within a certain period. For example, if an asset is to be written off to 5% of its original cost over 13 years, under the Straight Line Method the rate of depreciation will be 7.3% but the equivalent rate under Reducing Balance Method will be 20%.

The main advantage of the Reducing Balance Method is that during the first few years, when the charge on account of depreciation is heavier, the cost of repairs is usually small and thus, the total charge for each asset is distributed almost equal annually throughout its life, taking

cost of repairs also into account. What is claimed as an advantage for the Reducing Balance Method is a drawback in the case of the Straight Line Method. This can be overcome by building up a reserve for repairs and renewals. This is done by an equal amount determined on estimating the average cost of repairs and renewals being annually charged to the Statement of Profit and Loss and credited to the provision for repairs account. Against this provision for the expenditure on repairs and renewals is charged as and when incurred, with the result that the annual charge for depreciation and repairs is equalised.

The various important factors which the management should take into account while selecting a particular method are:

- (i) type of asset;
- (ii) the nature of the use of the asset;
- (iii) circumstances prevailing in the business; and
- (iv) state of the economy-whether stable or inflationary.

For example, in a stable economic condition, a going concern with steady operations may select the straight line method. Further certain assets like patents and trade marks should also be depreciated on a straight line basis because of their nature conditioned by a legally prescribed life. A company with uneven asset acquisition over the years may go for written down value method.

The method of depreciation is applied consistently to provide comparability of the results of the operation of the enterprises from period to period. A change from one method of providing depreciation to another is made only if adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statement of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the assets coming into use. The deficiency or surplus arising from recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of the past years, the deficiency is charged in the Statement of Profit and Loss. In case the change in method results in surplus, the surplus is credited to the Statement of Profit and Loss in the year in which such change is made. Such a change in method is a change in the accounting policy and its effect is quantified and disclosed.

**6.2.5 Determining the Amount of Depreciation:** The assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

- (i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
- (ii) expected useful life of the depreciable asset; and

(iii) estimated residual value of the depreciable asset.

The useful life of a depreciable asset is shorter than its physical life and is:

- (i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
- (ii) directly governed by extraction or consumption;
- (iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise, etc.; and
- (iv) reduced by obsolescence arising from such factors as:
  - (a) technological changes;
  - (b) improvement in production methods;
  - (c) change in market demand for the product or service output of the asset; or
  - (d) legal or other restrictions.

Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

The useful lives of major depreciable assets or class of depreciable assets may be reviewed periodically. Where there is revision of estimated useful life of an asset, the unamortised depreciation amount should be charged over the remaining useful life too.

An entity may adopt different types of methods of depreciation for different types of assets provided the same are adopted on a consistent basis. Even a company having plants at different locations may adopt different method of depreciation in the same accounting year. Further, it may be noted that the depreciation would be charged on pro-rata basis in respect of assets acquired during the financial year.

**6.2.6 Disclosure in the Statement of Profit and Loss and Balance Sheet of a Company:** Section 123 of the Companies Act, 2013 provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Schedule II "Useful lives to compute Depreciation", to the Companies Act, 2013. Schedule II to the Act provides that useful life of an asset shall not ordinarily be different from the useful life specified in Part 'C' to the said Schedule and the residual value of an asset shall not be more than 5% of the original cost of the asset. If a company does not use the useful life or residual value of the asset as provided in the Schedule II, then justification for the difference shall be disclosed in its financial statement.

Where during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such asset shall be calculated on a pro rata basis from the date of such addition, or as the case may be, upto the date on which such asset has been sold, discarded, demolished or destroyed.

If an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

The useful life or residual value of any specific asset as notified for accounting purpose by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of Schedule II.

The Schedule II to the Companies Act, 2013 needs disclosure in the financial statements about the depreciation method used and the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule II.

Schedule III "General Considerations for preparation of Balance Sheet and Statement of Profit and Loss of a Company", to the Companies Act, 2013, requires separate disclosure of depreciation charged and impairment losses/reversals along with a reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments.

Accounting Standard 6 requires following information to be disclosed in the financial statements;

- (i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;
- (ii) total depreciation for the period for each class of assets; and
- (iii) the related accumulated depreciation.

It also requires following disclosure of information in the financial statements alongwith the disclosure of other accounting policies;

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- (i) depreciation method used; and
- (ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule.

**6.2.7 Legal Necessity of Provision for Depreciation:** On account of the provision under Section 123 that, no dividend shall be declared except out of profits arrived at after providing for depreciation in accordance with the provisions of the Act, it has become obligatory for every company distributing dividend to make a provision for depreciation. However, it may be noted that Schedule II to the Companies Act, 2013 provides the useful lives to compute depreciation on the asset as well.

**6.2.8 Provision of Depreciation for Past Years:** Section 123(1) of the Companies Act, 2013 prescribes that if a company has not provided for depreciation for any previous financial year it shall, before declaring, or paying dividend, provide for such depreciation:

- (a) either out of the profits of that financial year, or
- (b) out of the profits of any other previous financial year or years.

The implication of this provision is that if, for example, the profits of a company for the year ending 31st March, 2015 are proposed to be distributed, and it is found that due to inadequacy of profits no provision for depreciation had been made for the year ended 31st March, 2014 it would be necessary to make provisions in respect of the depreciation, for the year ended 31st March, 2014 as well as 2015 and only the balance of the profits for the year 31st March, 2015 would be available for distribution as a dividend.

**Ascertainment of depreciation for computing net profits for the purpose of managerial remuneration:** Under Section 197(1) of the Companies Act, 2013 depreciation calculated in the manner specified in Section 198 of the Companies Act, 2013 must be deducted for arriving at the amount of net profits, on which remuneration payable to managerial personnel is to be calculated.

**6.2.9 Auditor's Duty as Regards Depreciation:** Apart from fixed assets in respect of which depreciation must be provided in the manner aforementioned, it also has to be provided on semi-permanent assets, e.g., patents, trademarks, blocks and dies, etc. Since the auditor is not in a position to estimate the working life of a majority of them, for this he has to rely on the opinion of persons who have a technical knowledge of the assets. He must, however satisfy himself that an honest attempt has been made to estimate the working life of each asset, that the total provision for depreciation is adequate and that the method adopted for determining that amount to be written off appears to be fair and reasonable. If he is of the opinion that the provision for depreciation is not adequate, he should report to the appropriate authority. He must also see that depreciation written off is properly disclosed in the Statement of Profit and Loss and the Balance Sheet.

**6.2.10 Revaluation of Fixed Assets:** In recent years, due to an abnormal rise in the price level, it has been suggested in many quarters that accountants should modify the practice that

so far prevailed of calculating the provision for depreciation on historical cost (*i.e.*, original cost of fixed assets) and may, for the purpose adopt the replacement cost basis. In support of such a view, it has been argued that, as a result of the rise in the price level, replacement costs of assets have gone up to such an extent that the depreciation provision, based on the original costs, does not leave in the business sufficient funds enabling it to replace its fixed assets. Thus when financial statements are prepared on a basis other than historical cost basis, it is necessary that depreciation should also be computed accordingly on the revised book value of the assets. The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the Statement of Profit and Loss the accumulated depreciation existing at the date of revaluation. Further an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to Statement of Profit and Loss except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to Statement of Profit and Loss in which case the increase is credited to Statement of Profit and Loss to the extent that it offsets the previously recorded decrease. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the Statement of Profit and Loss except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve. AS-6 on "Depreciation Accounting requires where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets.

**6.2.11 Impairment of Assets:** Besides charging annual depreciation on assets by the reason of normal wear and tear, effluxion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the asset can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as Impairment Loss. The treatment of impairment loss is similar to depreciation except the fact that impairment loss can be re-instated in future if the recoverable amount of the asset exceeds the carrying amount. Various external and internal sources of information can be taken as the basis of determining the impairment for Assets.

The auditor must ensure that provisions of AS 28, "Impairment of Assets" issued by the Institute are followed.

### 6.3 Reserves

**6.3.1 Reserves vs. Provision:** Reserves are amounts appropriated out of profits which are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the date of the Balance Sheet. In contradistinction, provisions are amounts charged against revenue to provide for:

- (i) depreciation, renewal or diminution in the value of assets; or
- (ii) a known liability, the amount whereof cannot be determined with substantial accuracy; or
- (iii) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

The difference between the two is that provisions are amounts set apart to meet specific liabilities of diminution in assets value. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. If a provision is in excess of the amount considered necessary, the same must be written back or credited to a Reserve Account.

Reserves are made up of amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. It will consist of the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves. It may be noted that the amount of a reserve is affected by the values placed on assets. If these are excessive, the real reserve might not exist at all or be smaller than the figure at which it is shown in the balance sheet.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose, e.g., to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

A capital reserve on the other hand represents surplus or profit earned in respect of certain types of transactions; for example, on sale of fixed assets at a price in excess of cost, realisation of profits on issue of forfeited shares or balances which because of their origin or



the purposes for which these are held, are not regarded by the directors as free for distribution as a dividend through the Statement of Profit and Loss. However, students may note that as per AS-5, profit or losses arising out of sale of fixed assets should be routed through Statement of Profit and Loss though they may be shown separately.

Capital Reserve is a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss. In its narrowest sense, therefore the description would include only share premium, capital redemption reserve, development rebate reserve and profit on reissue of forfeited shares. It may further be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve also would be a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

Students may further note that according to the format prescribed for the Balance Sheet in Schedule III to the Companies Act, 2013, the amount of capital and revenue reserves must be shown separately. Also capital redemption reserve and securities premium account must be segregated. Further, if there are more than one kind of revenue reserves, their nature and amounts must be disclosed; also the balance of the Statement of Profit and Loss, if in debit, should be shown as a negative figure under the head "Surplus" and therefore would be adjusted under the head "reserve and Surplus".

Schedule III further provides that the aggregate of amount are set aside or proposed to be set aside to reserves, if material, should be disclosed in the Statement of Profit and Loss. Similarly aggregate of amounts, if material, withdrawn from reserves should be disclosed.

Reserves either may be retained in the business as a part of the working capital or invested outside the business in marketable securities. To the extent additional capital can be usefully and profitably employed in the business, undistributed profits should be left in the business. For these when so employed, would earn a higher return than what they would if they were invested outside in the shares or debentures of another company. So much of the profits as cannot be usefully employed in the business as well as the part of the profits earned which necessarily must be invested outside the business, under some legal obligation *i.e.*, for the redemption of debentures, reserves should be invested in such securities which are easily realisable and the prices whereof are not liable to wide fluctuations. The term 'Reserves Fund' should be employed to describe a reserve only when the amount of reserve is invested outside the business and it is represented by the readily realised assets.

Reserves which are not disclosed in the Balance Sheet are known as secret or hidden reserves. Secret reserves can be created in the following ways:

- (i) By writing down fixed asset more than what is necessary.
- (ii) By writing off capital expenditure as though it were revenue.

- (iii) Under-valuation of inventory.
- (iv) By making an excessive provision for bad debts.
- (v) By making an excessive provision for contingencies or by continuing to carry forward provision even when they are not required.

Before the Companies Act, 1956 came into force, there were no restrictions on the creation of secret reserves except that whenever secret reserves were brought back into accounts, it was necessary to disclose the amount adjusted out of such reserves.

**Note:** Students may read the decision in the case *Rex vs. Kysant and Moreland* to acquaint themselves with the circumstances which led to the introduction of restrictions on the creation of secret reserves.

**6.3.2 Specific Reserves:** A specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association or the directors want to be provided for, such as replacement of fixed assets, expansion of the organisation, income-tax liability of the future, etc.

There may be slight confusion since some of the objects for which specified reserves are created, may also appear to be covered by a charge against revenue, for example, provision for bad and doubtful debts as well as reserve for bad and doubtful debts or a provision for repairs and renewals running along with a reserve for an identical purpose. The only distinction between the two is based on whether it is a charge against revenue or an appropriation of profits. To create any specific reserve existence of profit is essential. Any amount which the directors desire to retain or the Articles require the company to retain over and above provision, necessary for a true and fair disclosure of profit, is specific reserve unless the same is retained for a general purpose, when it would become a general reserve.

Normally, specific reserves are created to comply with the terms of the Articles of Association or in accordance with a decision of the Board to meet a particular situation which may arise in the future. Also some of the specific reserves may be required under contractual obligations or legal compulsion. An example of the former would be the fund for redemption of debentures; that of the latter would be the development rebate reserve which is compulsory if the advantage of the development rebate is to be enjoyed in respect of income-tax. Such specific reserves take on the character of capital reserves.

**Note 6(B) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Reserves and Surplus” in notes to accounts as follows:**

- (B) Reserve and Surplus
  - (i) Reserves and Surplus shall be classified as:
    - (a) Capital Reserves;
    - (b) Capital Redemption Reserve;
    - (c) Securities Premium Reserve;

- (d) Debenture Redemption Reserve;
  - (e) Revaluation Reserve;
  - (f) Share Options Outstanding Account;
  - (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
  - (h) Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.
- (Additions and deductions since last balance sheet to be shown under each of the specified heads)

## 6.4 Verification of Assets

**6.4.1 General Principles:** Verification of assets is an important audit process: by convention its scope has been limited to inspection of assets, where it is practicable, and collection of information about them on an examination of documentary and other evidence so as to confirm:

- (a) that the assets were in existence on the date of the balance sheet;
- (b) that the assets had been acquired for the purpose of the business and under a proper authority;
- (c) that the right of ownership of the assets vested in or belonged to the undertaking;
- (d) that they were free from any lien or charge not disclosed in the balance sheet;
- (e) that they had been correctly valued having regard to their physical condition; and
- (f) that their values are correctly disclosed in the balance sheet.

Verification of assets is primarily the responsibility of the management since the proprietor or the officials of the entity are expected to have a much greater intimate knowledge of the assets of the business as regards location, condition, etc. than that which an outsider might be able to acquire on their inspection. They alone thus are competent to determine the values at which these should be included in the Balance Sheet. The auditor's function in the circumstances is limited only to an appraisal of the evidence, their inspection and reporting on matters affecting their valuation, existence and title, observed in the course of such an examination. Principally, the auditor is required to verify the original cost of assets and to confirm, as far as practicable, that such a valuation is fair and reasonable. As regards the manner in which the original cost should be ascertained, there are well defined modes of valuation which he is expected to follow.

Assets are valued either on a 'going concern' or a 'break-up value' basis. The first mentioned basis considered appropriate when the concern is working and the second, when it has closed down and is being wound-up. AS - 1 mentions that "Going Concern" is one of the fundamental

accounting assumptions to be followed in preparation and presentation of financial statements. In case of non-observance, the fact that “Going Concern” assumption has not been followed is to be specified. If considered necessary, the auditor can also obtain the assistance of expert valuer. He must further ensure that the Balance Sheet discloses the basis on which different assets have been valued.

**6.4.2 Valuation of Assets:** Fixed assets are acquired for purpose of business with the object of earning revenue in the ordinary course of business; these are intended to be used and not sold, e.g., land, building, machinery, etc. Almost all fixed assets (except land and goodwill) suffer depletion or exhaustion due to efflux of time and their use or exploitation. In addition, almost all assets are subject to impairment taking into consideration its recoverable value in future. Mines and quarries are notable examples of the class of assets that are described as wasting assets, denoting that their value diminishes on exploitation, in contradistinction to the loss of value through use or obsolescence that takes place in the case of other assets. Floating assets are acquired for resale with a view to earning profits or are those that come into existence during the processes of trade or manufacture. All those, in the normal course of business, are quickly convertible into cash, e.g., inventory, trade receivable, bills receivable, etc.

**Fixed Assets:** Fixed assets are included in the Balance Sheet at their cost less depreciation and impairment loss. Cost includes all expenditure necessary to bring the assets into existence and to put them in working condition. It would be incorrect to value them at their sale price since these are not intended to be sold. For the very same reason, the fluctuations in the market values are ignored even when these are permanent. If these were taken into account, it would result in either under or over allocation of their cost. In case any government grant is received in relation to specific fixed assets then either the grant can be shown as deduction from cost of the asset or grant can be treated as deferred income which is recognised in Statement of Profit and Loss.

**Wasting Assets:** More as a result of custom than financial expediency, no specific provision to reduce the value of wasting assets exists in the Companies Act, 2013. For the first time, this matter was considered by the Court in the case *Lee v. Neuchatel Asphalt Company Limited* and it was held that it was not necessary for a company to provide depreciation on wasting assets to arrive at the amount of profits which it could distribute. It cannot, however, be contended that the value of wasting assets remains unaltered despite their exploitation year after year. On a consideration of this position, the Institute of Chartered Accountants in England and Wales, as early as 1944, recommended that provision for depreciation or depletion should be made in respect of every wasting asset, such as mine, on the basis of the estimated physical exhaustion that takes place. The amount that must be provided can be determined on ascertaining the proportion that the quantity of the output during the year bears to the total quantity that the mine is expected to yield during its normal working life. The unit for such a computation should be the unit of the refined produce and not that of the raw one. Schedule II to the Companies Act, 2013 covers cases in respect of which provisions of the accounting standards as applicable shall apply. On the very same consideration, if a mine has

been acquired on a lease, the total amount paid for the lease should preferably be amortised over the period of the lease in proportion to the output in each year. This may sometimes appear impracticable; under such a situation, amortisation on a time basis may be considered.

**Floating Assets:** In the case of these assets the attempt is to include them in the Balance-sheet at their realisable value. These, therefore, are valued either at cost or market value whichever is less. The term 'cost' refers to purchase price including duties and taxes, freight inwards and other expenditure directly attributable to acquisition less trade discount, rebates, duties drawbacks and subsidies, in the year in which they are accounted, whether immediate or deferred in respect of such purchase. The term 'market value' may either refer to "Net realisable value" or "the replacement cost".

- (i) **Net Realisable value-** Net Realisable value is the estimated selling price in the ordinary course of business less estimated costs of completion and the estimated costs necessarily to be incurred in order to make the sale.
- (ii) **Replacement Cost-** It refers to the price which would have to be paid for acquiring the same assets at the current market rate on the date of the Balance-sheet. The replacement cost is determined by taking into account the price that would have to be paid for purchasing the assets from normal sources of supply. In case free market for the assets does not exist it may not be possible to determine the replacement cost.

It may be noted here that in case of valuation of inventories, only net realisable value as a variant of market value has to be considered. This is in accordance with the Accounting Standard 2 on 'Valuation of Inventories'.

**Inventory:** It is a current asset held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or service for sale. The normally accepted accounting principle of valuation of inventory is at cost or net realisable value whichever is lower. This principle is in accordance with the AS 2 on 'Valuation of Inventories'. This general principle applies to valuation of all inventories except inventories of the following to which special considerations apply.

- (a) Work-in-progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, "Construction Contracts");
- (b) Work-in-progress arising in the ordinary course of business of service providers;
- (c) Shares, debentures and other financial instruments held as inventory; and
- (d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

The inventories referred to in (d) above are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a Government guarantee, or when a homogenous market exists and there is a negligible

risk of failure to sell. These inventories are excluded from the scope of this statement.

For instance, in the case of inventory of tea, coffee and rubber, held by the plantations which have produced them, with a view to showing in their annual accounts the true profits in respect of each crop, it is valued at the date of the Balance Sheet at the price at which it has been sold subsequently, reduced either by actual or estimated selling expenses pertaining thereto. And where inventories are held for maturing (e.g., rice, timber and wine), though their value increases substantially with the passage of time, these are usually valued at an amount which is equal to their cost plus storage charges. Where during storage the weight shrinks, an allowance for this factor is also made. In no case, however, the price applied is allowed to exceed the current market (selling) price of similar goods less costs necessarily to be incurred in order to make the sale.

Following the fundamental accounting assumption of consistency, whatever basis of valuation is adopted; it should be consistent from one period to another to prevent distortion of trading results disclosed by the annual accounts. Therefore, any change in the accounting policy relating to inventories (including the basis of comparison of historical cost with net realisable value and the cost formulae used) which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policy which has a material effect in the current period the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

**Different connotations of 'Cost':** The significance of this term varies in different circumstances on account of the nature of goods and the methods by which cost has been computed. Essentially, it refers to an appropriate combination of the cost of purchase, cost of conversion and other costs incurred in the normal course of business in bringing the inventories up to the present location and condition.

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- (a) abnormal amounts of wasted materials, labour, or other production costs;
- (b) storage costs, unless those costs are necessary in the production process prior to a further production stage;
- (c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- (d) selling and distribution costs.

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

The cost of inventories, other than those dealt with in paragraph 14 of AS-2, should be

assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

**Valuation of inventories below historical cost:** The historical cost of inventories may at times not be realised, e.g., if their selling prices have significantly declined, or if they become wholly or partially obsolete, or if the quantity of inventories is so large that it is unlikely to be sold/utilised within the normal turnover period and there exists a genuine risk of physical deterioration, obsolescence or loss on disposal. In such circumstances, it becomes necessary to write down the inventory to 'net realisable value,' in accordance with the principle of conservatism which requires that current assets should not be carried in the financial statements in excess of amounts expected to be realised in the ordinary course of business. Materials and other supplies held for use in the production of inventories are not written down below cost, if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

**Disclosure:** The financial statements should disclose-

- (a) the accounting policies adopted in measuring inventories, including the cost formula used; and
- (b) the total carrying amount of inventories and its classification appropriate to the enterprise.

**Investments:** The Companies Act has introduced a concept of trade investments. These are investments made by a company in the shares and in debentures of another, not sufficiently large as to make the other a subsidiary. Such investments are always valued at cost since the basic consideration in making the investment associates in trade.

The market value of shares or debentures of a company which are not quoted on the Stock Exchanges is ascertained on a consideration of the financial position of the company as disclosed by its last Balance Sheet and Statement of Profit and Loss. For this purpose, the dividend policy and the price at which shares have changed hands in the previous months also are taken into account.

Where shares or debentures have been acquired by a concern *in lieu* of services rendered in the promotion of a company (e.g., in pursuance of an underwriting contract) or in the part payment of purchase consideration, these are included in the Balance Sheet at cost, determined on a reference to the relative agreement in pursuance whereof the allotment has been made. For example, where shares have been allotted in consideration of subscription obtained to loans or debentures, these are valued at the amount paid for them, reduced by the amount of underwriting commission earned; the shares allotted in pursuance to a vendor's agreement are valued at the price specified in the agreement. As per AS-13, the cost of an investment should include acquisition charges such as brokerage, fees and duties. If an

investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

When an investment is sold for determining the amount of profit or loss resulting on its sales, it is necessary to first ascertain its cost. While doing so, a distinction is made between capital and revenue expenses and receipts. For instance the amount of brokerage paid on purchasing investment (Government Securities or debentures) is added to their cost. Costs such as transfer fees, stamp duty, etc. should be capitalised. But the amount, if any, paid on account of interest which had accrued due till the date of transaction is not taken into account for it is recoverable. Likewise, the value of bonus shares allotted subsequent to the purchase of the shares is not added to their cost. Then the cost of the original requisition would represent the cost for the total holding including bonus shares. However, the amount received on sale of 'right' in respect of new shares offered by the company may be deducted from the value of shares held, it being a capital receipt. On the very same consideration, any dividend received on shares for a period which had closed before the date of acquisition is treated as a capital receipt. As per AS-13, interest, dividend and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

As per AS-13 "Accounting for Investments", "an enterprise should disclose current investments and long term investments distinctly in its financial statements". Regarding valuation, it states as under:

"Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.



Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the Statement of Profit and Loss.

On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the Statement of Profit and Loss."

#### 6.4.3 General Principles Regarding Verification of Assets

- (i) Where a company or a partnership has taken over the assets of a going concern, the agreement of sale should be inspected and that amount paid for them ascertained. It should be further verified that the allocation of the total cost among the various assets is fair and reasonable.
- (ii) The cost of assets acquired piecemeal should be verified with their invoices, purchase agreements or ownership rights and the receipt of the sellers in respect of the price paid. It should be verified that expenditure on assets newly acquired and that on the renewal and replacement of old assets has been correctly recorded, consistent with the method that has been generally followed in the past.
- (iii) When an asset is sold, its sale-proceeds should be vouched by reference to the agreement, containing the terms and conditions of sale, counterfoil of the receipt issued to the purchaser or any other evidence which may be available. If the sale of a fixed asset has resulted in capital profit, it should be transferred to capital reserve. However, the profit limited to the original cost or a loss should be transferred to the Statement of Profit and Loss.
- (iv) It is obligatory for a company to provide for depreciation out of the profits in accordance with the provisions under sub-section (1) of section 123, before any profits can be distributed as dividend. The law requires that depreciation should be provided in the manner as specified in Schedule II to the Companies Act, 2013.
- (v) The existence of fixed assets, where practicable, should be verified by a physical inspection and, or by comparing the particulars of assets as are entered in the Schedule attached to the Balance Sheet, with the Plant or Property Register and reconciling their total value with the General Ledger balances.
- (vi) Wherever possible, all the securities and documents of title, cash, negotiable instruments, etc. representing the assets, should be inspected at the close of the last day of the accounting period. If this be not practicable and the examination is undertaken at the later date, a careful scrutiny of transactions subsequent to the date of the balance sheet must be made to ensure that the changes in their balance that have subsequently taken place are *bonafide* and are supported by adequate evidence.
- (vii) It should be ascertained that no unauthorised charge has been created against an asset and all the charges are duly registered and disclosed. Where shares or securities are lodged with a bank to secure a loan or an overdraft, a certificate should be obtained from the bank showing the nature of the charge, if any.
- (viii) Where assets, e.g., government securities, share scrips and debenture bonds are in the custody of a third party other than a bank, these must be inspected.

## 6.20 Auditing and Assurance

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(ix) Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

**Note 6(l) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Tangible Assets” in notes to accounts as follows:**

- (l) Tangible Assets
  - (i) Classification shall be given as:
    - Land
    - Buildings
    - Plant and Equipment
    - Furniture and Fixtures
    - Vehicles
    - Office Equipment
    - Others (specifying nature)

It is the duty of the management to ensure that the fixed assets of the company are in existence and for this purpose, it is important that physical examination of plant and machinery and other fixed assets should be carried out periodically depending upon the size of the company. The auditor is also required to report on the physical verification of the fixed assets by the management, and the treatment of the discrepancies, if any.

**6.4.4 Audit of Fixed Assets:** The Guidance Note on Audit of Property, Plant and Equipment issued by the ICAI recommends that verification of PPE (referred as fixed assets) consists of examination of related records and physical verification. The auditor should, normally, verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of PPE is primarily the responsibility of the management. The auditor must also consider the appropriateness of the accounting policies, including policies for determining which costs are capitalised, whether a cost or valuation model is followed and depreciation (including assessment of residual values) appropriately calculated.

As per the relevant Revised AS, the auditor should ensure that the entity has capitalised the assets as per the component approach, whereby a component or part of an asset which is significant in value compared to the total value of the asset or the useful life of which is different from that of the asset, has to be capitalised separately.

The verification of records would include verifying the opening balances of the existing PPE from records such as the Schedule of fixed assets, ledger or register balances to acquisition of new fixed assets should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds. The auditor must verify records to ensure that the assets under construction or pending Self-constructed fixed assets and capital work-in-progress should be verified with reference to the supporting documents such as contractors’

bills, work orders and independent confirmation of the work performed from other parties. When fixed assets have been written off or fully depreciated in the year of acquisition, the auditor should examine whether these were recorded in the fixed assets register before being written off or depreciated. In respect of retirement of fixed assets, the auditor should examine whether retirements were properly authorised, whether depreciation accounts have been properly adjusted, whether the sale proceeds, if any, have been accounted for and the resulting gains or losses, if material, have been properly adjusted and disclosed in the Statement of Profit and Loss. In case the asset is impaired the auditor must ensure that the asset has met the criteria as specified in AS 28, "Impairment of Assets". Further, if conditions so warrants, the reversal norms of impairment loss are duly complied with.

The ownership of assets like land and buildings should be verified by examining title deeds. In case the title deeds are held by other persons such as bankers or solicitors, independent confirmation should be obtained directly by the auditor through a request signed by the client.

Physical verification of fixed assets is primarily a responsibility of the management. The management is required to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by the management wherever possible and by examining the relevant working papers. The auditor should also examine whether the method of verification was reasonable in the circumstances relating to each asset. The reasonableness of the frequency of verification should also be examined by the auditor in the circumstances of each case. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with.

The auditor should see that the fixed assets have been valued and disclosed as per the requirements of law and generally accepted accounting principles. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted basis of accounting for depreciation. The Institute has also recommended that the company should provide depreciation so as to write off the asset over its normal working life. The company may provide depreciation with different useful life and residual value than as prescribed under Schedule II to the Companies Act, 2013, after disclosing the justification for the same.

Revaluation of fixed assets implies re-statement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of fixed assets. It would also include making technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisal appears reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

**6.4.5 Fixed Assets and requirement of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:**

**(A) Clause (i)(a) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.**

*What constitutes proper records is a matter of professional judgment made by the auditor after considering the facts and circumstances of each case. It is necessary that the aggregate original cost, depreciation or amortisation to date, and impairment loss, if any, as per these records under individual heads should tally with the figures shown in the books of account. It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account keeping (manual or computerized), the number of operating locations, the systems of control, etc. It may be noted that with the advent of the information technology, many companies are maintaining electronic records. The auditor may, therefore, accept electronic fixed assets register if the following two conditions are satisfied:*

- (1) The controls and security measures in the company are such that once finalised, the fixed assets register cannot be altered without proper authorization and audit trail.*
- (2) The fixed assets register is in such a form that it can be retrieved in a legible form. In other words, the emphasis is on whether it can be read on the screen or a hard copy can be taken. If this is so, one can contend that it is capable of being retrieved in a legible form.*

*In case the above two conditions or either of the two conditions are not satisfied, the auditor should obtain a duly authenticated print-out of the fixed assets register. In case the auditor decides to rely on electronically maintained fixed assets register, he should maintain adequate documentation evidencing the evaluation of controls that seek to ensure the completeness, accuracy and security of the register.*

*The auditor should examine whether the company has an appropriate mechanism in place to ensure compliance with this provision of Schedule II.*

*The purpose of showing the situation of the assets is to make verification possible. There may, however, be certain classes of fixed assets whose situation keeps changing, for example, construction equipment which has to be moved to sites. In such circumstances, it should be sufficient if record of movement/custody of the equipment is maintained.*

**(B) Clause (i)(b) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable intervals. The clause further requires the auditor to comment whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.**

*Physical verification of the assets has to be made by the management and not by the auditor. It is, however, necessary that the auditor satisfies himself that such verification was done and that there is adequate evidence on the basis of which he can arrive at such a conclusion. The auditor may prefer to observe the verification, particularly when verification of all assets can be made by the management on a single day or within a relatively short period of time. If, however, verification is a continuous process or if the auditor is not present when verification is made, then he should examine the instructions issued to the staff (which should, therefore, be in writing) by the management and should examine the working papers of the staff to substantiate the fact that verification was done and to determine the name and competence of the person who did the verification. In making this examination, it is necessary to ensure that the person making the verification had the necessary technical knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible for verification to be made by outside expert agencies engaged by the management for the purpose.*

*The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land.*

*The Order requires the auditor to report whether the management "at reasonable intervals" has verified the fixed assets. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.*

*The auditor is required to state whether any material discrepancies were noticed on*

*verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material. The auditor has, therefore, to use his judgement to determine whether a discrepancy is material or not. In making this judgement, the auditor should consider not merely the cost of the asset and its relationship to the total cost of all assets but also the nature of the asset, its situation and other relevant factors. If a material discrepancy has been properly dealt with in the books of account (which may or may not imply a separate disclosure in the accounts depending on the circumstances of the case), it is not necessary for the auditor to give details of the discrepancy or of its treatment in the accounts but he is required to make a statement that a material discrepancy was noticed on the verification of fixed assets and that the same has been properly dealt with in the books of account.*

## **6.5 Verification of Specific Assets**

**6.5.1 Land and Buildings:** Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not.

The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any second or subsequent mortgage. If ground rents, outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that the amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated considering appropriate useful lives, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated considering lesser useful lives.

If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculating the amount of depreciation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write up the book values of land and buildings even though their market values have increased but, where this has been done it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

- (i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.
- (ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.
- (iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.
- (iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.
- (v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.
- (vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

**6.5.2 Leasehold Property:** Various steps involved in the verification of leasehold rights are stated below-

- (i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument (section 107 of the Transfer of Property Act, 1882).
- (ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.
- (iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.
- (iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.
- (v) Ensure that the outlay as well as any legal expenses incurred to acquire the lease which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

A leasehold property, even where no premium has been paid for its acquisition, may sometime come to have a considerable value. In such a case, it may not be advisable to continue to show the asset as if it has no value. Nevertheless, where the leasehold rights have been revalued that fact should be clearly shown on the Balance Sheet till the account has been completely written off.

**6.5.3 Building:** If the building has been built or is in the course of construction, under a contract the auditor should verify the debit balance of the account by reference to the architect's certificate, as well as the contractor's receipts for amounts paid.

If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charged have been allocated to the account, is reasonable. The expenses charged should include all the expenditure necessary to bring the building into existence and to make it habitable. As a safeguard against any mistake arising in the expenses chargeable to the asset, the auditor should obtain a certificate from a responsible official in respect of total expenditure incurred on the construction of the building up to the date of the Balance Sheet. The amount of expenditure, where possible, should also be compared with the estimated cost of construction which may have been prepared by an architect or received with the tenders, if any, invited for construction. If there is a material discrepancy in the amount of actual and estimated expenditure, causes thereof should be reviewed.

**6.5.4 Intangible Assets:** An Intangible Asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible



resources such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated. If an item covered does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a license or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

As per AS-26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

**Note 6(J) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Intangible Assets” in notes to accounts as follows:**

- (J) Intangible Assets
  - (i) Classification shall be given as:
    - (a) Goodwill.
    - (b) Brands /trademarks.
    - (c) Computer software.
    - (d) Mastheads and publishing titles.
    - (e) Mining rights.

- (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
- (g) Recipes, formulae, models, designs and prototypes.
- (h) Licenses and franchise.
- (i) Others (specify nature).

**6.5.5 Plant and Machinery:** In the absence of a Plant, the Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.

In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Statement of Profit and Loss or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern.

Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register.

When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

**6.5.6 Patterns, Dies, Loose Tools, etc.:** Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such asset although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused inventory on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum inventory account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing inventory, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

**6.5.7 Furniture, Fittings and Fixtures:** The cost of these assets should be verified by reference to the invoices of suppliers. The entire expenditure incidental to their purchase also should be debited to the appropriate asset account. Further, the auditor should carefully scrutinise the details of the cost of additions debited to these accounts so as to ascertain that only the cost of genuine additions has been debited to such accounts. In the case of assets in regard to which there is a danger of loss through pilferage, there should be a satisfactory system of inventory control over them. It requires that each article of furniture is entered in a Inventory Register before its price is paid and the inventory number under which it is entered is painted over it also that at the end of each period, an inventory is prepared and reconciled with the Inventory Register and cost of all the articles which becomes unserviceable or have been lost is written off under proper authority.

**6.5.8 Motor Lorries, Vans, etc.:** The cost of these assets should be verified by reference to the invoices of suppliers and their ownership confirmed from permit and Registration Books. The auditor should also verify that the vehicles are covered by a comprehensive policy of insurance and adequate depreciation has been provided in respect of each of them. In case the number of vehicles is large, there should be a Vehicle Register similar to the Plant Register.

**6.5.9 Livestock:** A schedule of livestock at the close of the year should be obtained and entries in the same should be verified with the Register of Animals if it has been maintained. The entire stock of animals should be revalued on a uniform basis, from year to year, the cost of animals which have either been sold or have died during the year being excluded, and that of newly born or purchased during the year being added. There should be adjustment in the value of dry cattle on appropriate basis.

**6.5.10 Ships:** The cost of ships, if purchased outright, should be verified on a reference to the Bill of Sale and, if built to order, from the agreements with the shipbuilders. The ownership of the title should be verified from the certified copy of the entry in the port of registration unless the same is endorsed on the back of the Bill of Sale. Any mortgage or charge created on the ship is disclosed in the copy of 'entry' in case any exists, the same should be disclosed. In addition, it should be ascertained that the vessel is fully insured against all risks.

**6.5.11 Investments:** AS 13 on "Accounting for Investments" defines Investments as assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise.

An investment constitutes a significant portion of the total assets. An investment may be represented by Government securities, shares, debentures etc.

The following procedure should be adopted for verifying the investments-

- (i) Obtain schedule of securities and share in hand at the beginning of the audit period containing description, date of purchase, face value, book value (also the amount paid up if it differs from the book value), market value, rate of interest, date of payment of interest, date around which dividend is normally declared etc. In separate columns enter the amounts of interest and dividend received during the period, interest or dividend accrued or outstanding at the close of the period, tax deducted out of the first mentioned amount and deductible out of the second.
- (ii) Add to the above list, securities and shares purchased and sold during the year, giving the same description in regard to both.
- (iii) Balance this schedule and compare the closing balance with the control account in the General Ledger.
- (iv) The auditor should ascertain whether the investments made by entity are within its authority.
- (v) The auditor himself should also be satisfied that the transactions for the purchase/sale of investments are supported by due authority and documentation.
- (vi) The acquisition/disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc. special attention should be paid to investments purchased or sold cum-dividend, ex-dividend, cum-interest/ex-interest, cum rights/ex-rights or cum bonus/ex-bonus.
- (vii) Where the amount of purchases or sales of investments are substantial, the auditor should check the prices paid/received with reference to stock exchange quotations.
- (viii) The auditor should also physically inspect investments. The investments should be physically verified at the last date of the accounting year. In case investments are not held by the entity in its own custody - then certificate should be obtained from the relevant authority to the effect of holding of investments.

- (ix) In case investments are held otherwise than in the name of the entity, e.g. in the name of nominees/trustees, the auditor should ascertain the reasons for the same and examine relevant documentary evidence.
- (x) The auditor should also examine the relevant provisions of section 143(1) of the Companies Act, 2013 and see that a company other than an investment or banking company, whether so much of the assets of the company as represented by shares and debentures have been sold at a price less than that at which they were purchased by the company.
- (xi) The auditor should see title deeds of immovable properties and see that same have been properly classified.
- (xii) The auditor should satisfy that the investments have been valued and disclosed in the financial statements in accordance with the recognised accounting policies and practices and relevant statutory requirements. Reference to principles laid down in AS-13 on "Accounting for Investments" relating to valuation of investments will be necessary.
- (xiii) The auditor should examine whether in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.
- (xiv) The auditor may also see that any money raised through share issue to the extent remains unutilised has been shown under the head "Investments" and the manner in which the same has been invested should also be indicated.

**Note:** About accounting of dividend income by companies, the Company Law Board has prescribed a procedure. In terms of the procedure, dividend declared during the accounting year even though not received should be accounted for in the same year. If dividend is declared after the year is over, but before the annual accounts are finalised and if the dividend relates to the accounting year, the same also should be accounted for in the year itself.

Section 187 of the Companies Act, 2013 requires that all investments made by a company on its own behalf shall be made and held by it in its own name except in cases which are specifically exempt.

**Investment in the shares or debentures of a subsidiary:** The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc. All the particulars entered in the schedule should be verified with the relevant account in the General Ledger. He should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

The provisions contained in Part I of Schedule III to the Companies Act, 2013 require that shares held in a subsidiary should be shown separately. The shares or debentures of a

subsidiary are valued at cost. If the subsidiary has suffered a loss, then a provision for the proportionate part of the loss should be made in the accounts of the holding company.

**6.5.12 Investment in the Capital of a Partnership Firm:** This has now got to be disclosed separately. To establish the authenticity of this item the auditor should go through the partnership deed, noting the capital contributed by the company, and the latest Balance Sheet and the Statement of Profit and Loss, duly audited. The amount of the loss, if any, falling to the share of the company should be debited to the Statement of Profit and Loss; the share of profit should be similarly credited to the Statement of Profit and Loss. The auditor should see whether the firm has been duly registered and he will do well to note the particulars sent for registration.

**Note 6(K) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Non-Current Investments” in notes to accounts as follows:**

(K) Non-current Investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
  - (a) Investment property;
  - (b) Investments in Equity Instruments;
  - (c) Investments in preference shares;
  - (d) Investments in Government or trust securities;
  - (e) Investments in debentures or bonds;
  - (f) Investments in Mutual Funds;
  - (g) Investments in partnership firms;
  - (h) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
  - (a) Aggregate amount of quoted investments and market value thereof;

- (b) Aggregate amount of unquoted investments;
- (c) Aggregate provision for diminution in value of investments.

**Note 6(N) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Current Investments” in notes to accounts as follows:**

**(N) Current Investments**

**(i) Current investments shall be classified as:**

- (a) Investments in Equity Instruments;
- (b) Investment in Preference Shares
- (c) Investments in government or trust securities;
- (d) Investments in debentures or bonds;
- (e) Investments in Mutual Funds;
- (f) Investments in partnership firms
- (g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

**(ii) The following shall also be disclosed:**

- (a) The basis of valuation of individual investments;
- (b) Aggregate amount of quoted investments and market value thereof;
- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

**6.5.13 Patent Rights:** The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. If it has been purchased; the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are ‘alive’ and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained. The auditor should ensure that patents are being shown at cost less amortisation charges. The cost of a patent includes its purchase price and the registration cost if brought outright. If the patent has been developed by the client in-house, all development expenses,

legal charges, including registration fees and other direct costs incurred in creating it, should be capitalized. The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter. AS-26 has suggested ten years as useful life until and unless there is clear evidence that useful life is longer than ten years. As stated earlier, student may refer to AS-26 as well.

**6.5.14 Trademarks and Copyright:** The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortisation charges till date. The copyright and trademarks are generally revalued at cost less amortisation charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amortized over the period of legal validity or useful commercial life, whichever is shorter. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS-26 has suggested for every intangible assets useful life of ten years unless and until there is clear evidence that useful life is longer than ten years.

**6.5.15 Assets Abroad:** Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document. Such a certificate must disclose unequivocally that they are free from any charge or encumbrance. The auditor should state in his report whatever evidence has been produced for his verification.

**6.5.16 Development of Property:** Expenses when incurred for the development of any property and which cannot be conveniently added to the value of such property should be capitalized under this head and written off over the period during which the benefit from such development will accrue to the business. Examples may be expenses incurred in grading and preparing the soil for plantations, overhead removal cost for collieries and mines, etc. These expenses should be verified with reference to the budgets, sanction of the appropriate authority, technical report, if any, and the bills for actual expenditure incurred. It should also be ensured that appropriate write off has been made against these assets, keeping in view the period of benefit or the exploitation, as the case may be.

**6.5.17 Railway Siding:** For verification of this item it would be essential to refer to agreement with Railway for availing of the facility. All expenses connected with the laying of the rails and making individual agreements, the amount paid to the Railway, if any should make up the cost. The cost of the railway siding should also be appropriately depreciated



keeping in view the terms of agreement with the Railway, the permit or lease, if any, for the land used in providing the siding, etc.

**6.5.18 Endowment policies :** Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures and policies for other similar purposes, being in the nature of quasi-fixed assets, should be verified by inspection of the policies and the auditor should ascertain that the last premium on them has been duly paid.

## 6.6 Current Assets

**6.6.1 Inventory:** The valuation of inventory is frequently the main factor in determining the result shown by the accounts. Apart from the effect on the Balance Sheet, incorrect treatment of inventory would affect the profits of the year that has closed as well as that of the next following. The valuation of the closing inventory, therefore, is an important step essential for the determination of the profits of the year and also for truly disclosing the financial position of the concern at the close of the year. An auditor being intimately concerned with these aspects of financial statements, it is his duty to verify the existence of the inventory possessed by the concern at the end of the year and to ascertain that the same has been valued correctly on a consistent basis.

The precise duties in regard to verification of inventory are nowhere defined. Under the circumstances, these have to be deduced from an interpretation of the general responsibility of auditors in regard to the statements of accounts verified by them, especially in regard to inventory. These have been considered in a few English decisions.

Justice Lindsay, while delivering the famous judgement in the case of *Kingston Cotton Mills Co. Ltd.* (1896) observed: It is no part of the auditor's duty to take inventory. No one contends that it is so; he must rely on other people for details of the inventory in hand. In the case of a cotton mill, he must rely on some skilled person for the material necessary to enable him to enter the inventory as its proper value in the Balance Sheet.

In the same case, Justice Lopes observed as follows: "An auditor is not bound to be a detective, or as was said to approach his work with a foregone conclusion that there is something wrong. He is watchdog, but not a blood hound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest to rely upon their representations, provided he takes reasonable care."

In the case of the *Westminster Road Construction & Engineering Co. Ltd.* (1932), it was held that an auditor must make the fullest use of all materials available to him and although he is neither an inventory-taker and nor a valuer of work-in-progress, he will be guilty of negligence if he fails to take notice of all available evidence from which it could be reasonably deducted that the work-in-progress was overvalued.

The decision thus appear to have settled the following three principles for the general guidance of the auditor:

- (i) That it is no part of auditor's duty to take inventory.
- (ii) That for the purpose he can rely upon statements and reports made available to him in regard to the valuation of inventories so long as there is no circumstance which may arouse his suspicion and he is satisfied that the procedures in the matter of inventory taking and management are such as would enable it to give such a certificate and that these have been followed.
- (iii) That an auditor would be failing in his duty if he does not take reasonable care in verifying the statements of inventory which are put up to him according to the information in his possession and the expert knowledge expected of him in regard to methods of verification and inventory control.

The above view was almost accepted universally by accountants until as a result of the disclosures in the case of *McKesson and Robbins*, the auditors in the U.S.A decided to make physical contact with the inventories presented to them.

In United Kingdom, the situation also underwent a change in 1967 since the decision of the famous case in *Thomas Gerrard & Sons Limited*. The liquidator of Thomas Gerrard & Sons Limited succeeded in an action against the company's auditors. The Managing Director of the company manipulated cut-off procedures and included non-existent inventories in the accounts in order to pay huge dividends, which in fact were paid out of the capital. The auditors relied on the Kingston Cotton Mill unsuccessfully; because the learned judge pointed out that this decision also made reference to the absence of suspicious circumstances. In the instant case such circumstances were in plenty as many sales and purchase invoices at the yearend had been deliberately altered. The Judge further observed that in these circumstances the auditors should reasonably have attended the inventory taking.

Following this in 1968, the Institute of Chartered Accountants in England & Wales issued Auditing Statement U-9 advising positively that auditors should attend at inventory taking for the purpose of observing the client's procedures and ensuring that they were likely to result in a reliable count. In this context it is also necessary to consider that during the last fifty years, there has been a great advancement in the techniques and methods of inventory control. With the aid of modern methods of costing, accounting ratios and budgetary control, it is now possible to obtain more accurate information in regard to quantities and value of inventory. Besides, now-a-days greater attention is being paid by businessmen to inventory control and, as a result, the inventory records maintained are more amenable to tests and checks.

The provisions in the Companies Act, 2013 have also considerably advanced the responsibilities of auditors in this regard. Section 128 of the Act requires a company to maintain proper books of account. Such books of account must, it is believed, include books kept to record transactions in inventory. The Act empowers the Central Government to require companies engaged in production of such goods or providing such services as may be prescribed to maintain books as would furnish particulars in relation to utilisation of material or

labour or other items of cost as may be prescribed. Furthermore, by section 338(2)\* of the Companies Act, 2013 'proper books of account' have been defined to include statements of annual inventory taking and (except in case of goods sold by way of ordinary retail trade) of all goods sold and purchased.

**6.6.2 Verification of Inventories:** The responsibility for properly determining the quantity and value of inventories rests with the management of the entity.

It is therefore the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. Verification of inventories may be carried out by employing the following procedures:

- (a) examination of records;
- (b) attendance at inventory-taking;
- (c) obtaining confirmations from third parties;
- (d) examination of valuation and disclosure; and
- (e) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

**Examination of Records:** The entities usually maintain detailed inventory records in the form of stores/inventory ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

**6.6.3 Attendance at Inventory-taking:** Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the inventory-taking. The extent of auditor's attendance at inventory-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the inventory records maintained by the entity and of the analytical review procedures.

The procedures concerning the auditor's attendance at inventory-taking depend upon the method of inventory-taking followed by the entity. There are two principal methods of inventory-taking: periodic inventory-taking and continuous inventory-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at

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\* Section 338 of the Companies Act, 2013 not yet enforced.

the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous inventory-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous inventory-taking methods for certain inventories and carry out a full count of other inventories at a selected date. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to inventory-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. Where the auditor is present at the time of inventory-taking, he should observe the procedure of physical verification adopted by the inventory-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories. Proper attention should also be paid to the physical condition of inventories. Ideally, there should be no movement of inventories when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or despatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movement. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during inventory-taking (e.g. issues from stores to production departments). The auditor should also examine whether the entity has instituted appropriate 'cut-off procedures' to ensure that -

- (i) goods purchased but not received have been included in the inventories and the liability has been provided for;
- (ii) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the inventory-taking. The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with inventory records and other corroborative evidence, e.g., inventory statements submitted to banks. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for. Where continuous inventory-taking methods are being used by the entity, the auditor should pay greater attention to ascertaining whether the

management:

- (i) maintains adequate inventory records that are kept up-to-date;
- (ii) has satisfactory procedures for physical verifications of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and
- (iii) investigates and corrects all material differences between the book records and the physical counts.

The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

**6.6.4 Confirmations from Third Parties:** Where significant inventories of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the inventories of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the inventories held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. Auditor should also consider SA 505, "External Confirmation" when he has obtained confirmation from third parties.

**6.6.5 Examination of Valuation and Disclosure:** The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, of 'Valuation of Inventories' issued by the Council of the Institute of Chartered Accountants of India. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the inventory sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may ensure that appropriate adjustment is made to the inventories. The auditor should examine the evidence supporting the assessment of net realisable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realisable value. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

**6.6.6 Analytical Review Procedures:** In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories-

- (i) reconciliation of quantities of opening inventories, purchases, production, sales and closing inventories;
- (ii) comparison of closing inventory quantities and amounts with those of the previous year;
- (iii) comparison of the relationship of current year inventory quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;
- (iv) comparison of the composition of the closing inventory (for example raw materials as a percentage of total inventories, work-in-process as a percentage of total inventories) with the corresponding figures for the previous year;
- (v) comparison of current year gross profit ratio for the previous year;
- (vi) comparison of actual inventory, purchase and sales figures with the corresponding budgeted figures, if available;
- (vii) comparison of yield with the corresponding figure for the previous year;
- (viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;
- (ix) comparison of significant ratios relating to inventories with the industry norms if available. It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

**6.6.7 Work-in-progress:** The auditor may involve a technical expert in verification of work-in-progress if necessary. He may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date, particularly of items the production of which have been abandoned and for items the manufacture of which is not being actively undertaken provided cost sheets are available in respect of individual items or lots of jobs or work orders, which cannot be identified with physical work, these should be verified as follows:

- (i) Ascertain that the cost sheets are duly attested by the Works Engineer and Works Manager.
- (ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost-sheets by reference to the records maintained in respect of issues of materials, payment of wages and its classification and original evidence in respect of all expenditure included in the cost-sheets.
- (iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimate of cost expected to be maintained under actual operating conditions during a limited future period (wherever these have been developed).

- (iv) Ensure that the allocation of overhead expenses has been made on reasonable basis and that total of the overhead expenses does not include any amount in respect of selling distribution and office expenses.
- (v) Compare the cost-sheet in detail with that of the previous year both in regard to the composition of cost and the value placed on various components. If they vary materially, investigate the causes thereof.

**6.6.8 Inventory and requirement of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:**

**(A) Clause (ii)(a) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the management has conducted physical verification of inventory at reasonable intervals. According to Accounting Standard (AS) 2, "Valuation of Inventories":**

***"Inventories are assets-***

- (a) held for sale in the ordinary course of business;***
- (b) in the process of production for such sale; or***
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."***

***Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, stores and spares, consumables and loose tools awaiting use in the production process. It may be noted that packing materials are also included in inventories. Inventories do not include machinery spares covered by Accounting Standard (AS) 10, "Accounting for Fixed Assets", which can be used only in connection with an item of fixed asset and the use of which is expected to be irregular.***

***Physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases. It is, however, necessary that the auditor satisfies himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can arrive at such a conclusion. For example, the auditor may examine the documents relating to physical verification conducted by the management during the year as also at the end of the financial year covered by the auditor's report.***

***What constitutes "reasonable intervals" depends on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. The management of a company normally determines the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all***

*the items of inventories should be verified by the management of the company at least once in a year. It may be useful for the company to determine the frequency of verification by 'A-B-C' classification of inventories, 'A' category items being verified more frequently than 'B' category and the latter more frequently than 'C' category items.*

*(B) Clause (ii)(b) to Paragraph 3 of the CARO, 2015 requires the auditor to comment on the reasonableness and adequacy of the inventory verification procedures followed by the management of the company. In case the procedures of physical verification of inventories, in the opinion of the auditor, are not reasonable and adequate in relation to the size of the company and the nature of its business, the auditor has to report the same.*

*An auditor should obtain reasonable assurance about existence and condition of inventories. Observation of physical verification/examination of records of verification of inventory is the primary source of evidence for the purpose of reporting under this clause. While the physical verification of inventories is primarily the duty of the management, the auditor is expected to examine the methods and procedures of such verification. The auditor may, if considered appropriate by him, be also present at the time of stock-taking. The duties and responsibilities of the auditor while attending a stock taking by the management are governed by the principles laid down in the Standard on Auditing SA 501, Audit Evidence – Additional Considerations for Specific Items, issued by the Institute of Chartered Accountants of India. The auditor should establish the reasonableness and adequacy of procedures adopted for physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement.*

*There are two principal methods of physical verification of inventories: periodic and continuous. Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.*

*Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. The auditor has to use his*



*professional judgement regarding the nature, timing and extent of the procedures to be applied in forming his opinion for commenting on this clause. The auditor can rely upon the work of an internal auditor provided the auditor complies with the requirements of Standards on Auditing (SA) 610, "Using the Work of an Internal Auditor", issued by the Institute of Chartered Accountants of India.*

*The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.*

*The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., inventory statements submitted to banks.*

*Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:*

- (i) maintains adequate stock records that are kept up-to-date;*
- (ii) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and*
- (iii) investigates and corrects all material differences between the book records and the physical counts.*

*The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.*

*The auditor may determine the reasonableness and adequacy of the procedures of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The following are the documents which can be examined by the auditor in this regard:*

- (i) written instructions given by the management to the concerned staff engaged in the verification process;*
- (ii) physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;*
- (iii) summary sheets/consolidation sheets duly authenticated by the responsible officials;*

- (iv) *internal memos etc., with respect to the issues arising out of physical verification of inventory;*
- (v) *any other relevant documents evidencing physical verification of inventory.*

*In case where the inventories are material and the auditor is placing reliance on the records, documents, information and explanations provided by the management, it would be desirable that the auditor, in order to substantiate the fact that the physical verification is carried out in accordance with the procedure explained by the management, attends the physical verification. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories.*

*While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable or adequate.*

*(C) Clause (ii)(c) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the company is maintaining proper records of inventory. The clause also requires the auditor to comment whether any material discrepancies were noticed on physical verification of inventory and if so, whether those material discrepancies have been properly dealt with in the books of account.*

*What constitutes "proper records" has not been defined. However, in general, records relating to inventories should contain, inter alia, the following:*

- (i) *particulars of the item like nomenclature, nature, etc.*
- (ii) *identification code of the item;*
- (iii) *details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner;*
- (iv) *relevant document number and department identification, if any;*
- (v) *location.*

*If priced stores ledger is maintained, the records of the inventory should also disclose the prices at which the recording of the issues and receipts is made. The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents. The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained.*

*It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping (manual or computerized), the number of operating locations, the systems of control, etc. The Order further requires the auditor to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. If the item for which the discrepancy cannot be established is not material, the discrepancy, if any, will also not be material. For example, an item categorised as 'C' in ABC analysis might not be material and therefore, the discrepancy, if any, in regard to such an item would not be material. In other cases, however, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items to be specified.*

**6.6.9 Goods on Consignment:** Where a separate account in respect of each consignment is not being maintained and only memoranda accounts in respect of goods sent on consignment are kept, the auditor should make sure that inventories sent out on consignment but unsold have been included in the closing inventory; when a separate account in respect of each consignment is being maintained, the auditor should verify that the debit balance in each Consignment Account represents only the cost of unsold goods *plus* proportionate expenses incurred on their transport and transit insurance; also that a provision has been made for any damage or loss suffered by the inventory or for a fall in sale price.

**6.6.10 Goods on Approval:** The auditor should ensure that any goods sent to customers on approval which were unsold at the close of the year have not been treated as sold and are shown in the account as Inventory on Approval and are valued at lower of the cost or market value. In case they are reported to have suffered any damage, a provision for the same should be made.

**6.6.11 Goods in Bond:** Where some of the goods are in bond, it is usual to have separate inventory sheets for them. The particulars of inventory entered on them should be examined by reference to bond warrants. If the same are pledged with some bank, a certificate should be obtained from the bank. The bonded goods should be valued at cost or market value, whichever is less. The value placed on such inventory should be counter-checked by reference to relevant invoices from foreign suppliers.

**6.6.12 Contracts in Course of Completion:** In the field of building construction, a contract may sometime extend over two or more years. When that happens, it is necessary to value the work-in-progress at the end of each year. In such a case, it would obviously be incorrect to value the work-in-progress at cost and postpone determination of profit to the year when the construction is finally completed and possession thereof made over, for it will lead to no profit being shown till the final year. Such a procedure will not be acceptable either to the shareholders or to the taxing authorities. One of the methods by which a part of profits can be included in the account of each year is the total profit anticipated in terms of percentage of total construction, computed in physical terms, completed each year. Such a procedure, however, may not yield a satisfactory result where the total income cannot be estimated accurately. In such an event, it is advisable to prepare cost statements and on that basis to compute value of work-in-progress at cost *plus* the part of the profit attributable thereto. As a general principle, it is imprudent to take credit for any anticipatory profit unless it is possible, reasonably and accurately, to estimate the amount. Even where this is practicable, the amount of profit should be estimated only in respect of instalments of contract price which has accrued or had been collected before the close of the year. In the case of contracts the construction of which is undertaken on the basis of 'cost *plus* percentage on cost' it would not be incorrect to take credit for the percentage of profit on cost actually incurred. For instance, if a factory is being built at 'cost *plus* 10% of cost basis' the process of incurring cost itself will establish a claim against the customer for the amount of such cost *plus* 10%. In such a case, it would not be incorrect to take credit for the whole of the profit which has actually accrued.

In the case of goods produced against a forward contract which are ready for delivery, the same should be valued at the price at which they will be delivered less expenses which will be incurred on their delivery. However, such a basis of valuation should not be adopted where there is any uncertainty regarding the terms of final settlement. For instance, where the buyer has to inspect the goods and he has the right to reject goods considered unsatisfactory, the contract price should not be applied until the goods have been inspected and approved.

**Note 6(O) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Inventories" in notes to accounts as follows:**

(O) Inventories

(i) Inventories shall be classified as:

- (a) Raw materials;
- (b) Work-in-progress;
- (c) Finished goods;
- (d) Stock-in-trade (in respect of goods acquired for trading);
- (e) Stores and spares;
- (f) Loose tools;
- (g) Others (specify nature).

- (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
- (iii) Mode of valuation shall be stated.

## 6.7 Trade Receivables

The term 'trade receivable' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Verification of trade receivables may be carried out by employing the following procedures:

- (a) Examination of records;
- (b) Direct confirmation procedure (also known as 'circularization procedure')
- (c) Analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor. The general procedure is as under:

### 6.7.1 Examination of Records

- (i) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the trade receivables balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.
- (ii) The auditor should check the agreement of balances as shown in the schedules of trade receivable with those in the ledger accounts. He should also check the agreement of the total of trade receivable balances with related control account. Any differences in this regard should be examined.
- (iii) Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant trade receivables, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.
- (iv) While examining the schedules of trade receivables with reference to the trade receivables' ledger accounts, the auditor should pay special attention to the following aspects:
  - (a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
  - (b) Where the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
  - (c) Whether transfers from one account to another are properly evidenced.
  - (d) Whether provisions for allowances, discounts and doubtful debts should recognise that even though a trade receivable may have confirmed the balance due by him, he may still not pay the same.

- (v) The following are some of the indications of doubtful and uncollectible debts, loans and advances:
  - (a) The terms of credit have been repeatedly ignored.
  - (b) There is stagnation, or lack of healthy turnover, in the account.
  - (c) Payments are being received but the balance is continuously increasing.
  - (d) Payments, though being received regularly are quite small in relation to the total outstanding balance.
  - (e) An old bill has been partly paid (or not paid), while later bills have been fully settled.
  - (f) The cheques received from the trade receivables have been repeatedly dishonoured.
  - (g) The debt is under litigation, arbitration, or dispute.
  - (h) The auditor becomes aware of unwillingness or inability of the trade receivable to pay the dues, e.g., a trade receivable has either become insolvent, or has closed down his business, or is not traceable.
  - (i) Amounts due from employees, which have not been repaid on termination of employment.
  - (j) Collection is barred by statute of limitation.
- (vi) Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.
- (vii) In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.
- (viii) The auditor should examine whether contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.

#### **6.7.2 Direct Confirmation Procedure**

- (i) The verification of balances by direct communication with trade receivables is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. The utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe,

based on his past experience or other factors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

- (ii) The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade receivables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.
- (iii) The confirmation date, the method of requesting confirmations, and the particular trade receivables from whom confirmation of balances is to be obtained are to be determined by the auditor.
- (iv) The trade receivables may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity.
- (v) The form of requesting confirmation from the trade receivables may be either (a) the 'positive' form of request, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request wherein the trade receivable is requested to respond only if he disagrees with the balance shown.
- (vi) The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities.
- (vii) The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the trade receivables are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the trade receivable balances.
- (viii) In many situations, it may be appropriate to use the positive form for trade receivables with large balances and the negative form for trade receivables with small balances.
- (ix) Where the number of trade receivables is small, all of them may be circularized, but if the trade receivables are numerous, this may be done on a sample basis. The sample list of trade receivables to be circularized, in order to be meaningful, should be based on a complete list of all trade receivable accounts. While selecting the trade receivables to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition,

the auditor should consider accounts in respect of which provisions have been made or balances have been written off during the period under audit of earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with *nil* balances. The nature of the entity's business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the trade receivables as a whole.

- (x) In appropriate cases, the trade receivable may send a copy of his complete ledger account for a specific period as shown in the entity's books.
- (xi) The method of selection of the trade receivables to be circularised should not be revealed to the entity until the trial balance of the trade receivables' ledger is handed over to the auditor. A list of trade receivables selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to trade receivables selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- (xii) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade receivables taken as a whole.

**(Note:** Students may note that SA 505, "External Confirmation" also provide guidelines for Direct Confirmation Procedure.)

**6.7.3 Analytical Review Procedures:** In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

- (i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;
- (ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;
- (iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;
- (iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;



- (v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;
- (vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of trade receivables, loans and advances. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgement of the auditor.

**6.7.4 Disclosure:** The auditor should satisfy himself that trade receivables, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

**Note 6(P) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Trade Receivables” in notes to accounts as follows:**

**(P) Trade Receivables**

- (i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.
- (ii) Trade receivables shall be sub-classified as:
  - (a) Secured, considered good;
  - (b) Unsecured considered good;
  - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

**6.7.5 Debts Requiring Special Consideration**

(i) **Debts due in foreign currency:** In the case of debts in a foreign currency, the auditor should find out by converting the amount into home currency whether it is more or less than the amount shown as recoverable. If there is any deficiency or appreciation, it should be appropriately adjusted in the Statement of Profit and Loss.

(ii) **Hire Purchase debts:** Strictly, these are not debts since the hirer has the option of returning the goods, the auditor should, therefore, confirm that the instalments of hire money which had accrued have been realised in case there are any arrears and the article which is the subject of hire purchase is still in the possession of the hirer, it should be necessary to set up a provision for the loss anticipated on sale of the asset or on account of non-recovery of the outstanding balance.

(iii) **Package and empties:** If packages are returnable but the customer has not deposited any security against their return, it is possible that he may fail to return them. Against such a contingency, the auditor should ask the client to make a suitable provision.

**6.7.6 Debt Due from Subsidiary Companies:** Because of the close relationship existing between a holding and subsidiary company, it is necessary for an auditor to find out that the debts shown as outstanding from the subsidiary are genuine and have resulted from transactions entered into in the normal course of business. Therefore, the balance outstanding should not only be confirmed with the statements of account received from the subsidiary but its basis should also be inquired into. If the debt is covered by an agreement, the same should also be referred to. If any security is deposited against due repayment of advances the same should be inspected. Debts due from a subsidiary company should be disclosed duly classified in the same way as accounts receivables.

**6.7.7 Bills Receivable:** If possible, the auditor should attend on the last day of the accounting period to inspect the bills in hand and agree their total with the balance in the Bills Receivable Account. If verification is postponed till some time, after the existence of the bills which had matured in between the two dates should be verified with the entries in respect of cash collected for them. If some bills were discounted after the date of the Balance Sheet, the collection of their proceeds should be verified. If any bills were dishonoured after the date of the Balance Sheet, the auditor should ascertain what portion, if any, of the amount will not be recovered and ensure that provision for the same has been made. Where a new bill is reported to have been taken in lieu of a bill which has matured, the auditor should inspect the bill. Where a number of bills are found to have been discounted before the close of the year the auditor should see that the amount of the bills so discounted is shown as a contingent liability on the Balance Sheet. If some of the bills are with bankers for collection, the auditor should obtain a certificate from them.

Generally, it will be the duty of the auditor to ensure that the bills were properly drawn and stamped and that they were not dishonoured. Where some of the bills were dishonoured, the auditor should ensure that they have been noted and protested.

**6.7.8 Advances:** These include amounts recoverable either in cash or in kind for value to be received, e.g., rates, taxes and insurance. The auditor should obtain a list of all advances and compare them with balances in the ledger. He should ascertain that advances were made under proper authority and were being recovered regularly by agreed instalments. Where there is an agreement the same should be inspected. In the case of old balances, the auditor should ensure that provision has been made in respect of irrecoverable advances. Particulars mentioned above in respect of trade receivables must also be given for advances.

**6.7.9 Loans:** In general the procedure outlined in regard to trade receivables is also applicable in the case of loans (and advances). Apart from verification of the balances of loans, the auditor should inspect loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, can be granted only if authorised by the Memorandum and Articles of Association in the case of company. In

addition, he should confirm that the loans advanced were within the competence of persons who had advanced the same, directors in the case of a company, partners in the case of a firm and trustees in the case of a trust. It should be verified that the loan has been acknowledged by the trade receivable and, in addition, he has executed a Pronote or a bill of exchange. If any security is deposited against due repayment of the loan, the same should be inspected. The loan should be classified for purposes of Balance Sheet in the same way as other debts. In addition, advances and loans to partnership firms in which the company or any of its subsidiaries is a partner should be disclosed.

Section 143(1) specifically requires an auditor to inquire among other things whether:

- (i) Loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members; and
- (ii) Loans and advances made by the company have been shown as deposits.

The Research Committee of the Institute of Chartered Accountants of India has given guidance for making inquiry as regards the above two matters. The guidance is on the following lines. The matter under clause (i) applies to loans and advances made by the company during the financial year under audit, whether they are outstanding on the date of the Balance Sheet or not. The inquiry should be made in the light of conditions prevailing when the loan or advance was made.

Loans and advances have not been defined anywhere in the Act. However, having regard to the requirement of clause (ii) above a distinction is obviously intended to be made between 'loans and advances' and 'deposits'. A deposit may be defined as the placing of money or money's worth with a third party, either for safe keeping or by way of security for the performance, of the depositor's obligations, or for the purpose of earning interest; in the last case the depositing with a party who customarily accepts deposits.

Items required to be disclosed under the head 'Loans and Advances' in Part I of Schedule III to the Companies Act, 2013, to the Act which do not fall within the above definition of a 'deposit' should be construed for the purpose of the clause (i) as "loans and advances."

Clause (i) applies to all loans and advances made 'on the basis of security' for this purpose would include any movable or immovable property, whether belonging to the borrower or not, of which either physical possession or over which a legally effective charge is given to the lender. In order to ascertain that loans and advances are "properly secured," auditors should make inquiries to ascertain that *prima facie*:

- (a) the company holds a legally enforceable security, and
- (b) the value of the security fully covers the amount of the loan or advance and is reasonably ascertained.

In order to comply with the requirements of paragraph (a) above, it will be necessary for the auditor to make appropriate inquiries depending upon the type of security. A few instances are

given below.

	Types of Security	Documents etc. to be seen
(a)	Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(b)	Government securities, and other securities, documents of title which are transferable by endorsement and delivery, e.g., Bills of Lading and Railway Receipts.	The scrips or other documents duly endorsed in favour of the lenders.
(c)	Legal mortgage of immovable property.	Duly registered mortgage deed.
(d)	Equitable mortgage of immovable properties	Title deeds deposited.
(e)	Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(f)	Pledge of goods.	Appropriate record of goods held at the Balance Sheet date.
(g)	Hypothecation of goods.	Deed of Hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date.

The valuation of securities which are quoted on a Stock Exchange would not normally present any problem. For securities which are not so quoted, the auditor should call for the last accounts of the company whose shares or debentures are deposited as securities and satisfy himself that *prima facie* the valuation placed on the securities or immovable property by the management is reasonable.

In the case of life insurance policies, the auditor shall call for evidence of the surrender value of the policy. In the case of inventories and other goods held on pledge or hypothecation, the auditor should ascertain that *prima facie* the valuation placed upon the goods is in order.

The loan agreement or correspondence in regard to the terms of the loan or advance should be seen. Where the loan or advance is made to a company, any charge on the assets of such a company should have been registered under section 77 of the Act in order to constitute an effective security.

Loans and advances on the basis of security would include loans or advances which are only partly secured from the commencement, or loans or advances which become partly secured owing to any reason, such as a fall in the value of the security. In the case of partly secured loans or advances, it would be advisable to show separately in the Balance Sheet as "Partly secured" including the extent to which they are secured.

The terms on which the loan or advance is made would primarily include the security, the interest

charged and the terms of payment. It would be difficult to lay down any general principles regarding the rate of interest which may be charged on loans and advances. Various considerations such as the position and standing of the borrower, type of security, purpose of the loan, prevailing market rate of interest, etc. would be taken into account. If the loan has been given for business considerations, e.g., loans to staff for purchase of cars, house, etc. loans to suppliers of raw materials or other goods there may be justification for interest being charged at a rate lower than the market rate or even, in appropriate circumstances, no interest being charged at all. However, when a loan is given only with a view to earning interest, the interest charged should be at the commercial rate. Particular attention should be paid to loans or advances to concerns in which the directors of the company are interested.

The question whether the terms on which a loan or advance has been given are “prejudicial to the interests of the company or its members” is a difficult one. Obviously, the auditor is not to inquire as to how such transactions of the company affect the interest of individual members (in their personal capacities). The reference to “members” should, therefore, be construed as a reference to the members of the company as a class, in their capacity as members. The members of company would be primarily interested in the reasonable return of their investment and the safety of their capital. The question whether a loan is prejudicial to the interest of the members should, therefore, be considered from this angle.

It should be noted that an inquiry has to be made as to whether loans and advances have been shown as deposits and not *vice versa*. It should be noted that a company cannot grant loans to directors unless the ordinary business of the company is that of making loans and advances.

**Note 6(L) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Long Term Loans and Advances” in notes to accounts as follows:**

(L) Long-term Loans and Advances

- (i) Long-term loans and advances shall be classified as:
  - (a) Capital Advances;
  - (b) Security Deposits;
  - (c) Loans and advances to related parties (giving details thereof);
  - (d) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:
  - (a) Secured, considered good;
  - (b) Unsecured, considered good;
  - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

**Note 6(R) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Short Term Loans and Advances” in notes to accounts as follows:**

**(R) Short-term Loans and Advances**

- (i) Short-term loans and advances shall be classified as:
  - (a) Loans and advances to related parties (giving details thereof);
  - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
  - (a) Secured, considered good;
  - (b) Unsecured, considered good;
  - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

## **6.8 Bank Balances**

These should be verified by reference to bank reconciliation statement, and the balance certificates received from banks. If a Bank Reconciliation statement includes a large number of uncleared items as on the date of the Balance Sheet, the auditor should verify that the items were subsequently collected. On the other hand, where a cheque issued for more than three months before the close of the year is shown in the bank reconciliation statement, the entry has to be reversed.

If audit is undertaken long after the close of the year, the auditor should reconcile the bank balances right up to the date on which he undertakes the audit.

**Note 6(Q) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose “Cash and cash equivalents” in notes to accounts as follows:**

**(Q) Cash and Cash Equivalents**

- (i) Cash and Cash Equivalents shall be classified as:

- (a) Balances with Bank;
- (b) Cheques, Drafts on hand;
- (c) Cash on hand;
- (d) Others (specifying nature).
- (ii) Earmarked balances with banks shall be separately stated.
- (iii) Balances with bank to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than 12 months maturity shall be disclosed separately.

The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements, if any. In this regard, the auditor should examine that following items are not included in cash and bank balances.

- (a) Temporary advances.
- (b) Stale or dishonoured of cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

## 6.9 Cash In Hand

In a Balance Sheet all the under mentioned cash balances are included under the above head (also refer para 6.8):

- (a) cash balance in hand;
- (b) petty cash balance in hand;
- (c) balances of stamps in hand;
- (d) cash in transit;
- (e) cash at branches; and
- (f) cash with agents;

The first three of the above mentioned items are verified by actual count. The cash in transit and that with branches and agents is verified from documentary evidence available in regard thereto and the advice in respect of their subsequent remittance in whole or a part.

Special care is necessary in regard to verification of cash balances for unless they are checked by surprise there can be no certainty that the cash produced for inspection was in

fact held by the custodian. For this reason, the cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the client or to his staff.

If there are more than one cash balances, e.g., when there is a cashier, a petty cashier, a branch cashier and, in addition, there are imprest balances with employees, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared containing details of the cash balance counted. If he is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash. Such an attempt is known to have been made in the past.

If the auditor is unable to check the cash balance on the date of the Balance Sheet, he should arrange with his client for all the cash balance to be banked and where this cannot conveniently be done on the evening of the close of the financial year, it should be deposited the following morning. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at the close of the year. In case this is not possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash. This should be done soon after the cash balances have been counted. The Cash Book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked. If any cheques or drafts are included in cash balance, the total thereof should be disclosed.

If there is any rough Cash Book or details of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book to prove that entries in the Cash Book are correct. If the auditor finds any slip, chit or I.O.U.s in respect of temporary advances paid to the employees included as part of the cash balance he should have them initialed by a responsible official and debited to Appropriate Accounts.

### **6.10 Miscellaneous Expenditure**

This refers to expenditure essentially of a revenue nature which, instead of being charged off as and when it is incurred, is accumulated in an account appropriately headed to indicate its nature and the balance in the account is written off over a period of years during which its benefit is expected to accrue to the business. Examples of expenses are: prepaid expenses, discount allowed on subscription to debentures. As long as the expense is not written off, it continues to appear as an asset on the right hand side of the Balance Sheet. Such expenses are described as Deferred Revenue Expenditure so as to indicate clearly the fact that though the expense is essentially of a revenue nature, its writing off has been deferred for adequate reasons.

For verification of such expenditure, it is necessary for the auditor to examine the evidence showing that the expense has actually been incurred as well as the proposed basis of its apportionment over a period of years. Wherever it is possible he must find out that the benefit of the expenditure which is being carried forward as an asset has not exhausted and, if so, the



amount should be written off. If during the year any amount has been added thereto, the justification for the same should be examined.

**Capitalisation of expenditure:** Where a part of the expenditure, in respect of a period before the business had reached the revenue earning state, has been capitalized, the auditor should carefully examine that the amount so capitalized only represents expenditure which could be considered to have directly or indirectly contributed to bring into existence assets. In this connection, he should examine the resolution of the Board of Directors by which the capitalisation has been authorised and the amount capitalized should be disclosed in the Balance Sheet.

Students may note that with the issuance of AS-26 on Intangible Assets, the concept of miscellaneous expenditure would undergo a change. Para 55 of AS 26, "Intangible Assets" which deals with recognition of an expense requires that an expenditure on an intangible item should be recognised as an expense when it is incurred unless:

- (a) it forms part of the cost of an intangible asset that meets the recognition criteria, viz., future economic benefit, cost measured reliability, etc.
- (b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. In this case, this expenditure should form part of the amount attributed to goodwill (Capital Reserve) at the date of acquisition.

The examples as prescribed in AS 26 of expenditure that are recognised as expenses are as under:

- (a) expenditure on start up activities, unless this expenditure is included in the cost of an item of fixed asset under AS 10.
- (b) expenditure on training activities.
- (c) expenditure on advertisement and promotional activities.
- (d) expenditure on relocating or re-organising part or all of an enterprise.

It should be further noted that, discount or premium relating to borrowing and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares can be treated as deferred revenue expenditure. Since, AS 26 does not apply to such item due to its specific nature.

## 6.11 Verification of Liabilities

**6.11.1 General Considerations:** Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include loans and borrowings, trade payables and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. An important feature of liabilities which has a significant effect on the related audit procedure is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the concern. For example, if the liability for certain expenses is found to have been omitted or understated, it would signify that against the revenue for the relative period, the full amount of expenses have not been charged. As a result, the figure of profit as disclosed by the Statement of Profit and Loss would be larger by the amount of the liability which has been omitted. Moreover, since the liability would not be included in the balance sheet, it would also be incorrect. Conversely, where a fictitious liability for expenses is adjusted in the accounts or when a liability is overstated, the result will be that the revenue would bear an increased charge which would have the effect of artificially reducing the profits. This will falsify the figure of profit or loss disclosed by the Statement of Profit and Loss. Besides, on account of the inclusion of the liability, the Balance Sheet also will be false, since it would include an undisclosed 'secret reserve'. The auditor must, therefore, apart from vouching the entries in regard to the adjustment of liabilities, verify at the close of the year that the liabilities stated in the Balance Sheet are in fact payable and all its liabilities that could be traced by the exercise of the diligence and care on the part of the auditor have been accounted for. He must also obtain a certificate from a responsible official stating that to the best of his knowledge and belief, all liabilities, whether for purchases (supplies) or expenses or any other account existing at the date of the Balance Sheet have been included in the books of account; also that all the contingent liabilities have been disclosed in footnote to the Balance Sheet have been provided for.

It has been held, *inter alia*, in the case of the *Westminster Road Construction Engineering Co. Ltd.* (1932) that the auditor must take care to satisfy himself that all the expenses and liabilities which the company could be expected to have incurred have been brought into accounts. In the course of his judgment in this case, the learned judges observed:

"If the auditor found that a company in the course of its business was incurring liabilities of a particular kind and that the trade payables sent in their invoices after an interval and that liabilities of the kind in question must have been incurred during the accountancy period under audit when he was making his audit, sufficient time has not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it becomes his duty to make specific inquiries as to the existence of such liabilities and also before he signed a certificate as to the accuracy of the Balance Sheet to go through the invoice files of the company in order to see that no invoice relating to liabilities has been omitted. The evidence has established to my satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this Balance Sheet.

**6.11.2 Loans and Borrowings:** Verification of liabilities may be carried out by employing the following procedures-

- (i) examination of records;
- (ii) direct confirmation procedure;
- (iii) examination of disclosure;

- (iv) analytical review procedures,
- (v) obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

**Loans and Borrowings:** The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.

The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.

In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.

The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.

Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.

Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such instalments.

The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

**Trade Payables and Other Current Liabilities:** The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the trade payable accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately before the year-end and verify that the related invoices have been recorded as purchases of the current year.

The auditor should check that the total of the trade payables' balances agrees with the related control account, if any; the difference, if any, should be examined.

The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of trade payables/acceptances.

The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.

While examining schedule of trade payables and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:

- (a) long outstanding items;
- (b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;
- (c) liabilities not correlated/adjusted against related advances;
- (d) authorisation and correctness of transfers from one account to another.

Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.

In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.

The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

**Disclosure Requirements as per Schedule III to the Companies Act, 2013 in respect of Trade Payables and Other Current Liabilities are:**

<b>Current liabilities</b>
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- |  |
|--|
| <ul style="list-style-type: none"><li>- Trade Payables</li><li>- Other current liabilities</li></ul> |
|--|

**Note 6(G) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Other Current Liabilities" in notes to accounts as follows:**

**(G) Other Current Liabilities**

The amount shall be classified as:

- (a) Current maturities of long-term debt;
- (b) Current maturities of finance lease obligations;
- (c) Interest accrued but not due on borrowings;

- (d) Interest accrued and due on borrowings;
- (e) Income received in advance;
- (f) Unpaid dividends;
- (g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities';
- (h) Unpaid matured deposits and interest accrued thereon;
- (i) Unpaid matured debentures and interest accrued thereon;
- (j) Other payables (specify nature).

**6.11.3 Provisions:** The term 'provision' means amounts retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy. Provisions include those in respect of depreciation or diminution in the value of assets, product warranties, service contracts and guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however, does not deal with provisions for depreciation or diminution in the value of assets.

The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.

**Provisions for Taxes and Duties:** The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.

**Provision for Gratuity:** The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity. The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

**Provision for Bonus:** In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

**Provision for Dividends:** The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

**Other Provisions:** Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

**6.11.4 Examination of Disclosure:** The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

The auditor should examine that the following have been disclosed in respect of contingent liabilities:

- (a) nature of each contingent liability;
- (b) the uncertainties which may affect the future outcome;
- (c) an estimate of the financial effect or a statement that such estimate cannot be made.

**6.11.5 Analytical Review Procedures:** In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions-

- (i) comparison of closing balances of loans and borrowings, trade payables, etc., with the corresponding figures for the previous year;
- (ii) comparison of the relationship between current year trade payable balances and the current year purchases with the corresponding figures for the previous year;
- (iii) comparison of actual closing balances of loans and borrowings, trade payables, etc., with the corresponding budgeted figures, if available;
- (iv) comparison of current year's ageing schedule of trade payables with the corresponding figures for the previous year;
- (v) comparison of significant ratios relating to loans and borrowings, trade payables, etc., with the similar ratios for other firms in the same industry, if available;
- (vi) comparison of significant ratios relating to loans and borrowings, trade payables, etc. with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor

**6.11.6 Special Considerations in the Case of a Company:** In addition to the procedures described above, the auditor should also employ the following procedures in the case of audit of a company-

- (i) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine

whether the provisions of sections 179 and 180(1)(c) of the Companies Act, 2013 are complied with.

- (ii) The auditor should examine the register of charges to ensure that charges created have been duly registered for the compliance of Section 77 of the Companies Act, 2013. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.
- (iii) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prime facie prejudicial to the interest of the company.
- (iv) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 73 of the Companies Act, 2013 and the rules framed thereunder/directions issued by the Reserve Bank of India.
- (v) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the relevant provisions of the Companies Act and the rules framed thereunder regarding transfer of unpaid or unclaimed dividends to Investor Education and Protection Fund.
- (vi) In case of declaration of dividend out of reserve, the auditor should verify that the conditions laid down in Companies (Declaration and Payment of Dividend) Rules, 2014 have been fulfilled before the declaration namely:
  - (a) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year.  
It is provided that this shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.
  - (b) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.
  - (c) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.
  - (d) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.
  - (e) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year(s) are set off against profit of the company of the current year.
- (vii) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax, sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.



(viii) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its investment; and other related requirements are complied with.

**6.11.7 Loan and requirement of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:**

**(A) Clause (iii)(a) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so, whether receipt of the principal amount and interest are also regular.**

*The clause covers not only the loan granted during the year but covers all loans including opening balances. Further, there is no stipulation regarding the loan being given in cash or in kind. In the absence of such stipulation, the auditor is required to disclose the requisite information in his report in respect of all kind of loans whether given in cash or in kind to the parties covered in the register maintained under section 189 of the Act.*

*Under section 189 of the Act, every company is required to maintain one or more registers which contain the particulars of all contracts or arrangements to which section 184(2) or section 188 of the Act applies. The auditor should obtain a list of companies, firms or other parties covered in the register maintained under section 189 of the Act from the management. The auditor should examine all loans (secured or unsecured) granted by the company to identify those loans granted to companies, firms or other parties covered in the register maintained under section 189 of the Act. It may so happen that a party listed in the register maintained under section 189 of the Act might take a loan from the company and repays it to the company during the financial year concerned. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared-up during the year and*

*report such transactions under the clause.*

*The clause mainly requires the auditor to report upon the regularity of receipt of principal amount of loans and interest thereon. The scope of auditor's inquiry under this clause shall be restricted in respect of companies, firms or other parties covered in the register maintained under section 189 of the Act.*

*The auditor has to examine whether the receipt of principal amount and interest is regular. The word 'regular' should be taken to mean that the principal and interest should normally be received whenever they fall due, respectively. If a due date for receipt of interest is not specified, it would be reasonable to assume that it falls due annually. A loan repayable on demand falls due as and when the lender calls back the loan. The auditor can make an assessment of the regularity only if the loan is demanded by the company since the question of regularity would be judged by consequent action of the company (payment or non-payment). If the lending company has not called back the loan, the auditor cannot comment under this sub-clause.*

*The following are some of the procedures that the auditor may apply to report on the clause:*

- (i) the auditor, while obtaining an understanding of the terms and conditions, should also take note of repayment schedule;*
- (ii) if loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of receipt of interest, for example, letters of understanding, acknowledgement by the party of the terms and conditions communicated by the company, etc.;*
- (iii) the dates of receipt of principal amount and payment of interest needs to be verified with reference to the books of accounts of the company to come to the conclusion whether such receipts are regular; and*
- (iv) if the results of the procedures mentioned above indicate any irregularity in receipt of principal and/or interest, the auditor should mention the fact in his report.*

*(B) Clause (iii)(b) to Paragraph 3 of the CARO, 2015 requires the auditor to comment, in the case of loans granted to the companies, firms or other parties covered in the register maintained under section 189 of the Companies Act, 2013, if overdue amount is more than ₹ 1 lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest.*

*This clause requires the auditor to state whether reasonable steps have been taken by the company for recovery of the principal and interest, wherever the overdue amount is more than ₹ 1 lakh. A loan is considered to be overdue when the payment has not been received on the due date as per the lending arrangements. In such cases, the auditor has to examine the steps, if any, taken for recovery of this amount. It may, however, be noted that the scope of the auditor's inquiry under this clause is restricted to loans*

*given by the company to parties covered in the register maintained under section 189 of the Act. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, the degree of delay in recovery and other similar factors, issue of reminders or the sending of an advocate's or solicitor's notice, may amount to "reasonable steps" even though no legal action is taken. The auditor is not, therefore, required to comment adversely on the mere absence of legal steps if he is otherwise satisfied that reasonable steps have been taken by the company. The auditor should ask the management to give in writing, the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations. The auditor should obtain sufficient appropriate audit evidence to support the fact that reasonable steps have been taken for recovery of the principal and interest of loans granted by the company.*

**6.11.8 Debentures:** Directors of a company in exercise of the powers vested in them may raise a loan by issue of debentures with or without creating a charge on the assets of the company. Debenture holders do not carry any voting right. When a charge is created over some of the assets, debentures are described as mortgage debentures. The terms and conditions on which the loan is raised, together with particulars of property charged as security for their repayment are printed on the debenture bonds along with a certificate showing that the charges have been registered with the Registrar. It is also customary to create a trusteeship in favour of one or more persons whenever some property belonging to the company is charged as security for repayment of the debentures. The trustees have all the powers of a mortgagee of the property and can act in whatever way they think expedient to safeguard the interest of the debenture holders. By the inclusion of section 71 in the Companies Act, 2013, the trustees of debenture holders now are expected to show the same degree of care and diligence in the administration of the debenture trusts as is required of other trusts. They cannot avoid such liability which they could do before. Both, the members and debenture holders, if they so desire, can obtain a copy of the trust-deed from the company. Section 71 of the said Act has also made compulsory for the appointment of trustees and creation of reserve for redemption of debentures.

The debenture bonds are issued to various debenture holders and entries in respect thereof are made in the books of account in exactly the same way as in the case of shares. Therefore, the amount received on issue of debentures should be vouched in the same way as the amount received on issue of capital. Apart from this, various steps involved in the verification of debentures are stated below:

- (a) Prepare a schedule of debenture holders with reference to the Register of debenture holders and tally the total amount received from debenture holders in respect of different classes of debentures that are outstanding for payment with the total of debentures as shown in the General Ledger.

- (b) Study the Memorandum and Articles of the company to ascertain the borrowing powers of the company; also whether any limitation has been placed thereon.
- (c) Inspect a copy of the debenture bonds that have been issued in acknowledgement of amounts received to ascertain the terms of repayment and particulars of the assets charged as security for the repayment of the amount; and verify that all the requirements of the Act relating to their issue have been fully complied with.
- (d) See in the case of mortgaged debentures, that the obligations undertaken by the company under the debentures trust deed to the debenture holders were being strictly honoured.
- (e) Confirm that the under mentioned information, required by law, has been duly communicated to the Registrar of Companies:
  - (i) Particulars of charges which have been created over the assets of the company as per the requirement of section 77 of the Act.
  - (ii) Information in regard to satisfaction in whole, or in part, of any charge relating to the property of the company prescribed under section 82 of the Act.
- (f) Verify that the provisions regarding redemption have been duly complied with. Debentures may be redeemable according to the terms of issue at specified dates by annual or other drawings or, at the option of the company, after due notice has been given of the intent to repay. While vouching entries in respect of debentures redeemed, the minutes of the Board of Directors authorising their redemption should be referred to for authority and the cancelled debenture bonds of stock certificates should be examined.

If some debentures have been purchased in the open market, it should be seen that these are being shown as an investment of Sinking Fund, if that is the case, in the Balance Sheet. Any surplus arising on redemption of debentures is capital profit. The balance left to the credit of the Sinking Fund Account, in excess of the value of debentures redeemed on account of profit made on sale of securities held as an investment of the Sinking Fund or due to debentures having been redeemed at a discount, would also be capital profit. However, according to Schedule III of the Companies Act, 2013, it is necessary to disclose the amount of such profits in the Statement of Profit and Loss of the company. When it is transferred directly to the Capital Reserve Account a note should be added to the Balance Sheet to disclose that fact.

If the debentures are redeemed at a premium, the amount of the premium should be written off by debit to the Statement of Profit and Loss.

If a Sinking Fund for redemption of debentures is being operated by means of an insurance policy it should be verified that the policy has been duly assigned in favour of trustees for debenture holders.

Debentures are treated as secured loans in the matter of disclosure of security provided against their repayment. The condition of redemption together with the earliest date it shall take place, are also disclosed.

If the company has redeemed certain debentures which it is authorised to reissue, particulars thereof also are disclosed. In the case of other loans, the provision for interest accrued but not matured for payment, is shown separately under the head 'Current Liabilities and Provisions' but that accrued and payable is shown along with the debentures. Such a distinction is made on the ground that whereas the first mentioned interest is a provision, the second is a debt.

**Debenture Trustee and Trust Deed:** Section 71 of the Companies Act, 2013 lays down the requirement of appointment of a debenture trustee by the company before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders.

It shall be the duty of every debenture trustee to:

- (i) inform the debenture holders immediately of any breach of the terms of issue of debentures or covenants of the trust deed;
- (ii) ensure that the debentures have been converted or redeemed in accordance with the terms of the issue of debentures;
- (iii) call for periodical status or performance reports from the company;
- (iv) ensure that the assets of the company issuing debentures and of the guarantors, if any, are sufficient to discharge the interest and principal amount at all times and that such assets are free from any other encumbrances except those which are specifically agreed to by the debenture holders;
- (v) perform such acts as are necessary for the protection of the interest of the debenture holders and do all other acts as are necessary in order to resolve the grievances of the debenture holders.

Where the company has issued any debentures, the auditor should also examine the debenture trust deed executed under section 71 of the Act. The auditor should pay particular attention to verify whether proper security has been created in favour of the debenture trust. The security creation can be verified by examining the relevant documents creating the charge in favour of the trustees for the debenture holders duly registered in the concerned Registrar's office if the security is an immovable property. Readers' attention is also invited to the Guidance Note on Certification of Documents for Registration of Charges issued by the Institute of Chartered Accountants of India. If the debentures have been issued towards the end of the year and the securities are created subsequently then, to present a complete and balanced picture while reporting the fact that the security in respect of debentures is yet to be created, the auditor would be well advised to also mention the reason for the same, viz., that the debentures have been issued only recently (specify the month of issue) and that the company is taking steps to create the security. However, he should report as above only where, as a result of his enquiries, he is satisfied that the non-creation of security is not due to deliberate or inadvertent delay on the part of the company and that it is in fact in the process of creation of security. If the company has not created any security, the auditor should report the fact in his report.

## 6.12 Contingent Liabilities

Accounting Standard 29 issued by the ICAI deals with the “Provisions, Contingent Liabilities and Contingent Assets”. According to it a contingent liability is (a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or (b) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resource embodying economic benefits will be required to settle the obligation; or (ii) a reliable estimate of the amount of the obligation cannot be made. According to this statement, the contingent liabilities are not recognized because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event not wholly within the control of the enterprise. In addition, the term “contingent liability is used for liabilities that do not meet the recognition criteria.

As per above definition, to be called contingent liability the following condition must be fulfilled: (a) possible obligation as a result of past event; (b) existence of which will be confirmed only by the occurrence or non-occurrence of future event; and (c) future event not wholly within the control of the enterprise.

An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

Some of the instances giving rise to contingent liabilities are:

- (a) law suits, disputes and claims against the entity not acknowledged as debts.
- (b) membership of a company limited by guarantee.

The following general procedures may be useful in verifying contingent liabilities:

- (a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.
- (b) Review of contracts, agreements and arrangements.
- (c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.
- (d) Review of terms and conditions of grants and subsidies availed under various schemes.
- (e) Review of records relating to contingent liabilities maintained by the entity.
- (f) Enquiry of, and discussions with, the management and senior officials of the entity.
- (g) Representations from the management.

The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

**Recognition Principles of Contingent Liability:** An enterprise should not recognize the contingent liability but it should be disclosed in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the obligation that is expected to be met by other parties is treated as contingent liability. Contingent liabilities are continuously assessed and if it becomes probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognized.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, para 68 of AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

- A brief description of the nature of the contingent liability and where practicable.
- An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
- Indication of the uncertainty relating to outflow.
- The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

**The Schedule III to the Companies Act, 2013 requires disclosure of following liabilities/commitments, to the extent not provided for, by way of a note:**

- (1) Classification of Contingent liabilities:
  - Claims against the company not acknowledged as debts;
  - Guarantees;
  - Other money for which the company is contingently liable.
- (2) Classification of Commitments into:
  - Estimated amount of contracts remaining to be executed on capital account and not provided for
  - Uncalled liability on shares and other investments partly paid
  - Other commitments (specifying nature)

The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified.

The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to undisputed claims and legal actions pending against the company.

**6.13 Events Occurring After the Balance Sheet Date**

Accounting Standard - 4 on "Contingencies and Events occurring after the Balance Sheet Date" deals with the treatment of contingencies and events occurring after the balance sheet date in financial statements. According to it, events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and in the case of any other entity by the corresponding approving authority. Some of such events may require adjustments to assets and liabilities as at the balance sheet date or may require disclosure. These are classified as under:

- (a) Adjusting events are those significant events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date, e.g., an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of the customer which occurs after the balance sheet date or that indicate that the fundamental accounting assumptions of going concern (*i.e.*, the continuance of existence or substratum of enterprise) is not appropriate.
- (b) Non-adjusting events are those events which do not relate to conditions existing at the balance sheet date. An example is the decline in the market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in the market value do not normally relate to the condition of the investments at the balance sheet date but reflects circumstances which have occurred in the following periods. However, disclosure is generally made of such events in case these represent unusual changes affecting the existence or sub-stratum of the enterprise at the balance sheet date. For example the destruction of a major production plant by a fire after the balance sheet will not require any adjustment in the balance sheet as no conditions existed on the date of the balance sheet. Non-adjusting events may be of such significance that they may be required disclosure in the report of the approving authority representing material changes and commitments affecting the financial position of the enterprise. In case disclosure of events occurring after the balance sheet is required, the auditor should see that the following information has been provided:
  - (i) the nature of the events; and
  - (ii) an estimate of the financial effect or a statement that such an estimate cannot be made.
- (c) There is another category of events which although take place after the balance sheet date are required to be reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared after the balance sheet in respect of the period covered by the financial statements.



### 6.14 Prior Period and Extraordinary Items and Changes in Accounting Policies

The objective of AS-5 on the above subject is to prescribe the classification and disclosure of certain items in the Statement of Profit and Loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

This Statement does not deal with the tax implications of extraordinary items, prior period items, change in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

**Net Profit or Loss for the Period:** All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

- (a) profit or loss from ordinary activities, and
- (b) extraordinary items.

**Prior Period Items:** Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

**Extraordinary Items:** Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

When items of income and expense within profit and loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

**Profit or Loss from Ordinary Activities:** When items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with the above paragraph include:

- (a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;
- (b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;
- (c) disposals of items of fixed assets;
- (d) disposals of long-term investments;
- (e) legislative changes having retrospective application;
- (f) litigation settlements; and
- (g) other reversals of provisions.

**Changes in Accounting Estimates** - In preparation of financial statements, it is inevitable to estimate certain items due to inherent uncertainties in business activities. For example estimates may be required of bad debts, inventory obsolescence or the useful lives of depreciable assets.

A change in accounting estimates is not equivalent to change in accounting policy. For example change from straight line method to WDV method would amount to change in accounting policy. Change in useful life would be treated as change in accounting estimate.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- (a) the period of the change, if the change affects the period only; or
- (b) the period of the change and future periods, if the change affects both.

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

**Changes in Accounting Policies** - As per AS-1, consistency is one of the fundamental accounting assumptions. Moreover, users should be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

A change in an accounting policy should be made only if the adoption of a different accounting policy is required by status or for compliance with an accounting standard or if it is considered

that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Any change in an accounting policy which has a material effect should be disclosed. The impact of and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.